

AMERICAN NATIONAL BANKSHARES INC.  
Form 10-Q  
August 04, 2017  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2017.

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO .

Commission file number: 0-12820

AMERICAN NATIONAL BANKSHARES INC.  
(Exact name of registrant as specified in its charter)

VIRGINIA 54-1284688  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

628 Main Street  
Danville, Virginia 24541  
(Address of principal executive offices) (Zip Code)

(434) 792-5111  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YesxNoo

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months.

YesxNoo

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company  Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YesoNox

At July 31, 2017, the Company had 8,642,913 shares of Common Stock outstanding, \$1 par value.



AMERICAN NATIONAL BANKSHARES INC.

Index	Page
<u>Part I.</u>	<u>FINANCIAL INFORMATION</u>
<u>Item 1.</u>	<u>Financial Statements</u>
	<u>Consolidated Balance Sheets as of June 30, 2017 (unaudited) and December 31, 2016</u>
	<u>3</u>
	<u>Consolidated Statements of Income for the three and six months ended June 30, 2017 and 2016 (unaudited)</u>
	<u>4</u>
	<u>Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2017 and 2016 (unaudited)</u>
	<u>5</u>
	<u>Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2017 and 2016 (unaudited)</u>
	<u>6</u>
	<u>Consolidated Statements of Cash Flows for the six months ended June 30, 2017 and 2016 (unaudited)</u>
	<u>7</u>
	<u>Notes to Consolidated Financial Statements (unaudited)</u>
	<u>8</u>
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>
	<u>35</u>
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u>
	<u>57</u>
<u>Item 4.</u>	<u>Controls and Procedures</u>
	<u>59</u>
<u>Part II.</u>	<u>OTHER INFORMATION</u>
<u>Item 1.</u>	<u>Legal Proceedings</u>
	<u>60</u>
<u>Item</u>	<u>Risk Factors</u>
<u>1A.</u>	<u>60</u>
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>
	<u>60</u>
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u>
	<u>60</u>
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>
	<u>60</u>
<u>Item 5.</u>	<u>Other Information</u>
	<u>60</u>
<u>Item 6.</u>	<u>Exhibits</u>
	<u>61</u>
<u>SIGNATURES</u>	<u>62</u>

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

American National Bankshares Inc.

Consolidated Balance Sheets

(Dollars in thousands, except per share data)

	(Unaudited) (*)	
	June 30, 2017	December 31, 2016
Assets		
Cash and due from banks	\$23,765	\$ 20,268
Interest-bearing deposits in other banks	62,164	32,939
Securities available for sale, at fair value	280,503	346,502
Restricted stock, at cost	5,501	6,224
Loans held for sale	2,379	5,996
Loans, net of unearned income	1,288,693	1,164,821
Less allowance for loan losses	(13,632)	(12,801)
Net loans	1,275,061	1,152,020
Premises and equipment, net	26,265	25,439
Other real estate owned, net of valuation allowance of \$248 in 2017 and \$134 in 2016	1,686	1,328
Goodwill	43,872	43,872
Core deposit intangibles, net	1,351	1,719
Bank owned life insurance	18,381	18,163
Accrued interest receivable and other assets	23,545	24,168
Total assets	\$1,764,473	\$ 1,678,638
Liabilities		
Demand deposits -- noninterest bearing	\$390,603	\$ 378,600
Demand deposits -- interest bearing	218,714	209,430
Money market deposits	339,106	283,035
Savings deposits	125,237	120,720
Time deposits	389,181	378,855
Total deposits	1,462,841	1,370,640
Short-term borrowings:		
Customer repurchase agreements	48,282	39,166
Other short-term borrowings	—	20,000
Long-term borrowings	9,991	9,980
Junior subordinated debt	27,775	27,724
Accrued interest payable and other liabilities	8,531	9,748
Total liabilities	1,557,420	1,477,258
Shareholders' equity		
Preferred stock, \$5 par, 2,000,000 shares authorized, none outstanding	—	—
Common stock, \$1 par, 20,000,000 shares authorized, 8,642,913 shares outstanding at June 30, 2017 and 8,618,051 shares outstanding at December 31, 2016	8,595	8,578
Capital in excess of par value	75,691	75,076

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-Q

Retained earnings	123,795	119,600
Accumulated other comprehensive loss, net	(1,028 )	(1,874 )
Total shareholders' equity	207,053	201,380
Total liabilities and shareholders' equity	\$1,764,473	\$ 1,678,638

(\* ) - Derived from audited consolidated financial statements.

The accompanying notes are an integral part of the consolidated financial statements.

3

---

American National Bankshares Inc.  
Consolidated Statements of Income

(Dollars in thousands, except per share data) (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Interest and Dividend Income:				
Interest and fees on loans	\$13,752	\$ 11,642	\$26,456	\$ 23,757
Interest and dividends on securities:				
Taxable	1,133	1,150	2,287	2,234
Tax-exempt	509	817	1,144	1,640
Dividends	84	93	163	184
Other interest income	125	67	234	125
Total interest and dividend income	15,603	13,769	30,284	27,940
Interest Expense:				
Interest on deposits	1,352	1,314	2,552	2,611
Interest on short-term borrowings	14	1	42	2
Interest on long-term borrowings	81	81	161	162
Interest on junior subordinated debt	244	213	483	421
Total interest expense	1,691	1,609	3,238	3,196
Net Interest Income	13,912	12,160	27,046	24,744
Provision for Loan Losses	350	50	650	100
Net Interest Income After Provision for Loan Losses	13,562	12,110	26,396	24,644
Noninterest Income:				
Trust fees	908	961	1,820	1,891
Service charges on deposit accounts	501	514	985	1,006
Other fees and commissions	733	656	1,445	1,328
Mortgage banking income	462	365	991	657
Securities gains, net	331	222	590	588
Brokerage fees	192	223	384	427
Income from Small Business Investment Companies	6	72	32	238
Other	215	354	372	529
Total noninterest income	3,348	3,367	6,619	6,664
Noninterest Expense:				
Salaries	4,733	4,031	9,532	8,246
Employee benefits	1,130	1,055	2,313	2,169
Occupancy and equipment	1,148	1,059	2,216	2,158
FDIC assessment	134	193	263	381
Bank franchise tax	263	256	519	512
Core deposit intangible amortization	203	288	368	576
Data processing	502	459	989	903
Software	271	274	550	571
Other real estate owned, net	68	76	111	209
Other	2,259	1,965	4,291	3,849
Total noninterest expense	10,711	9,656	21,152	19,574
Income Before Income Taxes	6,199	5,821	11,863	11,734
Income Taxes	1,920	1,733	3,521	3,518
Net Income	\$4,279	\$ 4,088	\$8,342	\$ 8,216

Net Income Per Common Share:

Basic	\$0.50	\$ 0.47	\$0.97	\$ 0.95
Diluted	\$0.49	\$ 0.47	\$0.96	\$ 0.95

Average Common Shares Outstanding:

Basic	8,640,648	8,610,156	8,636,954	8,610,998
Diluted	8,659,168	8,619,833	8,655,173	8,616,873

The accompanying notes are an integral part of the consolidated financial statements.

American National Bankshares Inc.  
 Consolidated Statements of Comprehensive Income  
 (Dollars in thousands) (Unaudited)

	Three Months Ended June 30,	
	2017	2016
Net income	\$4,279	\$4,088
Other comprehensive income:		
Unrealized gains on securities available for sale	879	583
Tax effect	(307 )	(204 )
Reclassification adjustment for gains on sales of securities	(331 )	(222 )
Tax effect	116	78
Other comprehensive income	357	235
Comprehensive income	\$4,636	\$4,323

The accompanying notes are an integral part of the consolidated financial statements.

American National Bankshares Inc.  
 Consolidated Statements of Comprehensive Income  
 (Dollars in thousands) (Unaudited)

	Six Months Ended June 30,	
	2017	2016
Net income	\$8,342	\$8,216
Other comprehensive income:		
Unrealized gains on securities available for sale	1,890	2,805
Tax effect	(661 )	(982 )
Reclassification adjustment for gains on sales of securities	(590 )	(588 )
Tax effect	207	206
Other comprehensive income	846	1,441
Comprehensive income	\$9,188	\$9,657

The accompanying notes are an integral part of the consolidated financial statements.



## American National Bankshares Inc.

## Consolidated Statements of Changes in Shareholders' Equity

(Dollars in thousands, except per share data) (Unaudited)

	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2015	\$ 8,605	\$ 75,375	\$ 111,565	\$ 2,290	\$ 197,835
Net income	—	—	8,216	—	8,216
Other comprehensive income	—	—	—	1,441	1,441
Stock repurchased (47,976 shares)	(48 )	(1,155 )	—	—	(1,203 )
Stock options exercised (4,134 shares)	4	97	—	—	101
Vesting of restricted stock (3,046 shares)	3	(3 )	—	—	—
Equity based compensation (30,995 shares)	8	439	—	—	447
Cash dividends paid, \$0.48 per share	—	—	(4,133 )	—	(4,133 )
Balance, June 30, 2016	\$ 8,572	\$ 74,753	\$ 115,648	\$ 3,731	\$ 202,704
Balance, December 31, 2016	\$ 8,578	\$ 75,076	\$ 119,600	\$ (1,874 )	\$ 201,380
Net income	—	—	8,342	—	8,342
Other comprehensive income	—	—	—	846	846
Stock options exercised (3,300 shares)	3	70	—	—	73
Vesting of restricted stock (6,468 shares)	7	(7 )	—	—	—
Equity based compensation (21,562 shares)	7	552	—	—	559
Cash dividends paid, \$0.48 per share	—	—	(4,147 )	—	(4,147 )
Balance, June 30, 2017	\$ 8,595	\$ 75,691	\$ 123,795	\$ (1,028 )	\$ 207,053

The accompanying notes are an integral part of the consolidated financial statements.

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-Q

American National Bankshares Inc.  
Consolidated Statements of Cash Flows  
(Dollars in thousands) (Unaudited)

	Six Months Ended June 30,	
	2017	2016
Cash Flows from Operating Activities:		
Net income	\$8,342	\$8,216
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	650	100
Depreciation	913	949
Net accretion of acquisition accounting adjustments	(1,029 )	(1,353 )
Core deposit intangible amortization	368	576
Net amortization of securities	996	1,356
Net gains on sale or call of securities	(590 )	(588 )
Gain on sale of loans held for sale	(774 )	(514 )
Proceeds from sales of loans held for sale	43,421	30,465
Originations of loans held for sale	(39,030 )	(31,377 )
Net loss on other real estate owned	3	64
Valuation allowance on other real estate owned	74	76
Net loss on sale of premises and equipment	—	8
Equity based compensation expense	559	447
Earnings on bank owned life insurance	(218 )	(227 )
Deferred income tax expense (benefit)	1,138	(1,763 )
Net change in interest receivable	263	(858 )
Net change in other assets	(1,232 )	151
Net change in interest payable	(13 )	13
Net change in other liabilities	(1,204 )	625
Net cash provided by operating activities	12,637	6,366
Cash Flows from Investing Activities:		
Proceeds from sales of securities available for sale	55,403	9,317
Proceeds from maturities, calls and paydowns of securities available for sale	26,075	63,183
Purchases of securities available for sale	(14,585 )	(93,501 )
Net change in restricted stock	723	(50 )
Net increase in loans	(123,113)	(51,143 )
Proceeds from sale of premises and equipment	—	1
Purchases of premises and equipment	(1,739 )	(269 )
Proceeds from sales of other real estate owned	78	852
Net cash used in investing activities	(57,158 )	(71,610 )
Cash Flows from Financing Activities:		
Net change in demand, money market, and savings deposits	81,875	29,697
Net change in time deposits	10,326	6,028
Net change in customer repurchase agreements	9,116	12,758
Net change in other short-term borrowings	(20,000 )	—
Common stock dividends paid	(4,147 )	(4,133 )
Repurchase of common stock	—	(1,203 )
Proceeds from exercise of stock options	73	101
Net cash provided by financing activities	77,243	43,248

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-Q

Net Increase (Decrease) in Cash and Cash Equivalents	32,722	(21,996 )
Cash and Cash Equivalents at Beginning of Period	53,207	95,337
Cash and Cash Equivalents at End of Period	\$85,929	\$73,341

The accompanying notes are an integral part of the consolidated financial statements.

7

---

AMERICAN NATIONAL BANKSHARES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Accounting Policies

The consolidated financial statements include the accounts of American National Bankshares Inc. (the "Company") and its wholly owned subsidiary, American National Bank and Trust Company (the "Bank"). The Bank offers a wide variety of retail, commercial, secondary market mortgage lending, and trust and investment services which also include non-deposit products such as mutual funds and insurance policies.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, goodwill and intangible assets, unfunded pension liability, other-than-temporary impairment of securities, accounting for merger and acquisition activity, accounting for acquired loans with specific credit-related deterioration, the valuation of deferred tax assets and liabilities, and the valuation of other real estate owned ("OREO").

All significant inter-company transactions and accounts are eliminated in consolidation, with the exception of the AMNB Trust and the MidCarolina Trusts, as detailed in Note 8.

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the results of the interim periods. The results of operations for the interim periods are not necessarily indicative of the results that may occur for any other period. Certain reclassifications have been made to prior period balances to conform to the current period presentation. These reclassifications did not have an impact on net income and were considered immaterial. These statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

Adoption of New Accounting Standard

During the first quarter of 2017, the Company adopted Accounting Standards Update ("ASU") 2016-09, "Compensation-Stock Compensation (Topic 718): Improvements to Employer Share- Based Payment Accounting." This ASU simplifies several aspects of the accounting for share-based payment award transactions, one of which is the recognition of excess tax benefits and deficiencies related to share-based payments, including tax benefits of dividends on share-based payment awards. Prior to the adoption of ASU 2016-09, such tax consequences were recognized as components of additional paid-in capital. With the adoption of this ASU, tax benefits and deficiencies are recognized within income tax expense. In accordance with the adoption provisions of ASU 2016-09, the results for the second quarter and first six months of 2016 include only the excess tax (expense) benefits attributable to the second quarter and first six months of 2016 in the amount of \$2,000 and \$50,000, respectively.

Recent Accounting Pronouncements

In January 2016, the Financial Accounting Standards Board ("FASB") issued ASU 2016-01, "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments in ASU 2016-01, among other things: (1) requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (2) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (3) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables); and (4) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in this ASU are effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently assessing the impact that ASU 2016-01 will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606,

Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company is currently assessing the impact that ASU 2016-02 will have on its consolidated financial statements.

During June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for Securities and Exchange Commission ("SEC") filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements.

During August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments", to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The amendments should be applied using a retrospective transition method to each period presented. If retrospective application is impractical for some of the issues addressed by the update, the amendments for those issues would be applied prospectively as of the earliest date practicable. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-15 to have a material impact on its consolidated financial statements.

During January 2017, the FASB issued ASU No. 2017-01, "Business Combinations (Topic 805): Clarifying the Definition of a Business". The amendments in this ASU clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Under the current implementation guidance in Topic 805, there are three elements of a business-inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a "set") that is a business usually has outputs, outputs are not required to be present. In addition, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs. The amendments in this ASU provide a screen to determine when a set is not a business. If the screen is not met, the amendments (1) require that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (2) remove the evaluation of whether a market participant could replace missing elements. The ASU provides a framework to assist entities in evaluating whether both an input and a substantive process are present. The amendments in this ASU are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. The amendments in this ASU should be applied prospectively on or after the effective date. No disclosures are required at transition. The Company does not expect the adoption of ASU 2017-01 to have a material impact on its consolidated financial statements.

During January 2017, the FASB issued ASU No. 2017-04, "Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment". The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option

to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are SEC filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company does not expect the adoption of ASU 2017-04 to have a material impact on its consolidated financial statements.

During March 2017, the FASB issued ASU 2017-07, "Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost." The amendments in this ASU require an employer that offers defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under Topic 715 to report the service cost component of net periodic benefit cost in the same line item(s) as other compensation costs arising from services rendered during the period. The other components of net periodic benefit cost are

required to be presented in the income statement separately from the service cost component. If the other components of net periodic benefit cost are not presented on a separate line or lines, the line item(s) used in the income statement must be disclosed. In addition, only the service cost component will be eligible for capitalization as part of an asset, when applicable. The amendments are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. Early adoption is permitted. The Company does not expect the adoption of ASU 2017-07 to have a material impact on its consolidated financial statements.

During March 2017, the FASB issued ASU 2017-08, "Receivables-Nonrefundable Fees and Other Costs (Subtopic 310 20), Premium Amortization on Purchased Callable Debt Securities." The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption and provide the disclosures required for a change in accounting principle. The Company is currently assessing the impact that ASU 2017-08 will have on its consolidated financial statements.

During May 2017, the FASB issued ASU 2017-09, "Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting." The amendments provide guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic 718. The amendments are effective for all entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted, including adoption in any interim period, for reporting periods for which financial statements have not yet been issued. The Company is currently assessing the impact that ASU 2017-09 will have on its consolidated financial statements.

#### Note 2 – Securities

The amortized cost and fair value of investments in debt and equity securities at June 30, 2017 and December 31, 2016 were as follows (dollars in thousands):

	June 30, 2017			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
Federal agencies and GSEs	\$93,406	\$ 23	\$ 1,737	\$91,692
Mortgage-backed and CMOs	79,334	423	689	79,068
State and municipal	97,297	2,167	259	99,205
Corporate	8,108	212	5	8,315
Equity securities	1,288	935	—	2,223
Total securities available for sale	\$279,433	\$ 3,760	\$ 2,690	\$280,503
	December 31, 2016			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
Federal agencies and GSEs	\$106,379	\$ 62	\$ 2,387	\$104,054
Mortgage-backed and CMOs	79,917	514	938	79,493
State and municipal	145,757	2,540	782	147,515
Corporate	13,392	123	23	13,492
Equity securities	1,288	660	—	1,948
Total securities available for sale	\$346,733	\$ 3,899	\$ 4,130	\$346,502





## Restricted Stock

Due to restrictions placed upon the Bank's common stock investment in the Federal Reserve Bank of Richmond ("FRB") and Federal Home Loan Bank of Atlanta ("FHLB"), these securities have been classified as restricted equity securities and carried at cost. The restricted securities are not subject to the investment security classification and are included as a separate line item on the Company's Consolidated Balance Sheet. The FRB requires the Bank to maintain stock with a par value equal to 3.0% of its outstanding capital and an additional 3.0% is on call. The FHLB requires the Bank to maintain stock in an amount equal to 4.5% of outstanding borrowings and a specific percentage of the Bank's total assets. The cost of restricted stock at June 30, 2017 and December 31, 2016 was as follows (dollars in thousands):

	June 30, December 31,	
	2017	2016
FRB stock	\$ 3,573	\$ 3,559
FHLB stock	1,928	2,665
Total restricted stock	\$ 5,501	\$ 6,224

## Temporarily Impaired Securities

The following table shows estimated fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2017. The reference point for determining when securities are in an unrealized loss position is month-end. Therefore, it is possible that a security's market value exceeded its amortized cost on other days during the past twelve-month period. Available for sale securities that have been in a continuous unrealized loss position are as follows (dollars in thousands):

	Total		Less than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Federal agencies and GSEs	\$83,671	\$ 1,737	\$83,671	\$ 1,737	\$—	\$ —
Mortgage-backed and CMOs	60,908	689	59,334	660	1,574	29
State and municipal	14,541	259	13,480	237	1,061	22
Corporate	1,553	5	1,553	5	—	—
Total	\$160,673	\$ 2,690	\$158,038	\$ 2,639	\$2,635	\$ 51

Federal agencies and GSEs: The unrealized losses on the Company's investment in 21 government sponsored entities ("GSE") securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at June 30, 2017.

Mortgage-backed securities: The unrealized losses on the Company's investment in 38 GSE mortgage-backed securities were caused by interest rate increases. Four of these securities were in an unrealized loss position for 12 months or more. The contractual cash flows of those investments are guaranteed by an agency of the U.S.

Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost basis of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at June 30, 2017.

Collateralized Mortgage Obligations: The unrealized losses associated with two private GSE collateralized mortgage obligations ("CMO") were due to normal market fluctuations. One of these securities had been in an unrealized loss position for 12 months or more. The contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost basis of the Company's investments. Because the decline in market value is attributable to changes in interest

rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at June 30, 2017.

State and municipal securities: The unrealized losses on 21 state and municipal securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at June 30, 2017.

Corporate securities: The unrealized losses on two corporate securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at June 30, 2017.

Restricted stock: When evaluating restricted stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Company does not consider restricted stock to be other-than-temporarily impaired at June 30, 2017, and no impairment has been recognized.

The table below shows estimated fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities had been in a continuous unrealized loss position, at December 31, 2016 (dollars in thousands):

	Total		Less than 12 Months		12 Months or More	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Federal agencies and GSEs	\$89,597	\$ 2,387	\$89,597	\$ 2,387	\$—	\$ —
Mortgage-backed and CMOs	57,762	938	56,076	911	1,686	27
State and municipal	47,221	782	47,221	782	—	—
Corporate	2,895	23	2,895	23	—	—
Total	\$197,475	\$ 4,130	\$195,789	\$ 4,103	\$1,686	\$ 27

#### Other-Than-Temporary-Impaired Securities

As of June 30, 2017 and December 31, 2016, there were no securities classified as other-than-temporarily impaired.

#### Realized Gains and Losses

The following table presents the gross realized gains and losses on and the proceeds from the sale of securities during the three and six months ended June 30, 2017 and 2016 (dollars in thousands):

	Three Months Ended June 30, 2017	Six Months Ended June 30, 2017
Realized gains (losses):		
Gross realized gains	\$341	\$605
Gross realized losses	(10 )	(15 )
Net realized gains	\$331	\$590
Proceeds from sales of securities	\$13,884	\$55,403

	Three Months Ended June 30, 2016	Six Months Ended June 30, 2016
Realized gains (losses):		

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-Q

Gross realized gains	\$222	\$593
Gross realized losses	—	(5 )
Net realized gains	\$222	\$588
Proceeds from sales of securities	\$3,146	\$9,317

12

---

## Note 3 – Loans

Loans, excluding loans held for sale, at June 30, 2017 and December 31, 2016, were comprised of the following (dollars in thousands):

	June 30, 2017	December 31, 2016
Commercial	\$236,418	\$ 208,717
Commercial real estate:		
Construction and land development	132,322	114,258
Commercial real estate	590,093	510,960
Residential real estate:		
Residential	211,305	215,104
Home equity	113,580	110,751
Consumer	4,975	5,031
Total loans	\$1,288,693	\$ 1,164,821

## Acquired Loans

The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheets at June 30, 2017 and December 31, 2016 are as follows (dollars in thousands):

	June 30, 2017	December 31, 2016
Outstanding principal balance	\$91,983	\$ 104,172
Carrying amount	85,283	96,487

The outstanding principal balance and related carrying amount of acquired impaired loans, for which the Company applies FASB Accounting Standards Codification ("ASC") 310-30 to account for interest earned, as of the indicated dates are as follows (dollars in thousands):

	June 30, 2017	December 31, 2016
Outstanding principal balance	\$32,206	\$ 34,378
Carrying amount	27,040	28,669

The following table presents changes in the accretable yield on acquired impaired loans, for which the Company applies FASB ASC 310-30, for the six months ended June 30, 2017 and the year ended December 31, 2016 (dollars in thousands):

	June 30, 2017	December 31, 2016
Balance at January 1	\$6,103	\$ 7,299
Accretion	(1,460 )	(3,232 )
Reclassification from nonaccretable difference	374	2,197
Other changes, net*	717	(161 )
	\$5,734	\$ 6,103

\*This line item represents changes in the cash flows expected to be collected due to the impact of non-credit changes such as prepayment assumptions, changes in interest rates on variable rate acquired impaired loans, and discounted payoffs that occurred in the quarter.

## Past Due Loans

The following table shows an analysis by portfolio segment of the Company's past due loans at June 30, 2017 (dollars in thousands):

	30- 59 Days Past Due	60-89 Days Past Due	90 Days + Past Due and Still Accruing	Non- Accrual Loans	Total Past Due	Current	Total Loans
Commercial	\$67	\$109	\$140	\$25	\$341	\$236,077	\$236,418
Commercial real estate:							
Construction and land development	249	—	241	61	551	131,771	132,322
Commercial real estate	426	—	278	811	1,515	588,578	590,093
Residential:							
Residential	942	132	952	1,012	3,038	208,267	211,305
Home equity	71	8	—	201	280	113,300	113,580
Consumer	21	7	—	7	35	4,940	4,975
Total	\$1,776	\$256	\$1,611	\$2,117	\$5,760	\$1,282,933	\$1,288,693

The following table shows an analysis by portfolio segment of the Company's past due loans at December 31, 2016 (dollars in thousands):

	30- 59 Days Past Due	60-89 Days Past Due	90 Days + Past Due and Still Accruing	Non- Accrual Loans	Total Past Due	Current	Total Loans
Commercial	\$50	\$—	\$—	\$19	\$69	\$208,648	\$208,717
Commercial real estate:							
Construction and land development	60	12	—	64	136	114,122	114,258
Commercial real estate	—	127	339	773	1,239	509,721	510,960
Residential:							
Residential	1,280	117	248	1,802	3,447	211,657	215,104
Home equity	229	—	—	289	518	110,233	110,751
Consumer	6	5	—	18	29	5,002	5,031
Total	\$1,625	\$261	\$587	\$2,965	\$5,438	\$1,159,383	\$1,164,821

## Impaired Loans

The following table presents the Company's impaired loan balances by portfolio segment, excluding acquired impaired loans, at June 30, 2017 (dollars in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	\$ 18	\$ 17	\$ —	\$ 17	\$ 1
Commercial real estate:					
Construction and land development	71	71	—	155	4
Commercial real estate	1,067	1,064	—	1,305	38
Residential:					
Residential	443	446	—	378	17
Home equity	145	145	—	131	5
Consumer	7	7	—	9	—
	\$ 1,751	\$ 1,750	\$ —	\$ 1,995	\$ 65
With a related allowance recorded:					
Commercial	78	77	5	78	2
Commercial real estate:					
Construction and land development*	61	62	—	213	—
Commercial real estate*	95	95	—	224	—
Residential:					
Residential	1,086	1,085	9	1,498	17
Home equity	222	220	1	320	1
Consumer*	7	7	—	13	—
	\$ 1,549	\$ 1,546	\$ 15	\$ 2,346	\$ 20
Total:					
Commercial	\$ 96	\$ 94	\$ 5	\$ 95	\$ 3
Commercial real estate:					
Construction and land development	132	133	—	368	4
Commercial real estate	1,162	1,159	—	1,529	38
Residential:					
Residential	1,529	1,531	9	1,876	34
Home equity	367	365	1	451	6
Consumer	14	14	—	22	—
	\$ 3,300	\$ 3,296	\$ 15	\$ 4,341	\$ 85

\*Allowance is reported as zero in the table due to presentation in thousands and rounding.

In the table above, recorded investment may exceed unpaid principal balance due to acquired loans with a premium and loans where unearned costs exceed unearned fees.



The following table presents the Company's impaired loan balances by portfolio segment, excluding acquired impaired loans, at December 31, 2016 (dollars in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	\$ 24	\$ 24	\$ —	\$ 12	\$ 2
Commercial real estate:					
Construction and land development	158	157	—	198	16
Commercial real estate	1,916	1,917	—	1,409	107
Residential:					
Residential	557	567	—	318	38
Home equity	6	6	—	153	16
Consumer	9	9	—	10	1
	\$ 2,670	\$ 2,680	\$ —	\$ 2,100	\$ 180
With a related allowance recorded:					
Commercial*	\$ 19	\$ 19	\$ —	\$ 78	\$ 1
Commercial real estate:					
Construction and land development*	64	65	—	272	10
Commercial real estate*	48	48	—	286	7
Residential:					
Residential	1,639	1,639	22	1,593	32
Home equity	386	385	1	345	4
Consumer*	18	18	—	14	—
	\$ 2,174	\$ 2,174	\$ 23	\$ 2,588	\$ 54
Total:					
Commercial	\$ 43	\$ 43	\$ —	\$ 90	\$ 3
Commercial real estate:					
Construction and land development	222	222	—	470	26
Commercial real estate	1,964	1,965	—	1,695	114
Residential:					
Residential	2,196	2,206	22	1,911	70
Home equity	392	391	1	498	20
Consumer	27	27	—	24	1
	\$ 4,844	\$ 4,854	\$ 23	\$ 4,688	\$ 234

\*Allowance is reported as zero in the table due to presentation in thousands and rounding.

In the table above, recorded investment may exceed unpaid principal balance due to acquired loans with a premium and loans where unearned costs exceed unearned fees.

The following tables show the detail of loans modified as troubled debt restructurings ("TDRs") during the three and six months ended June 30, 2017 included in the impaired loan balances (dollars in thousands):

Loan Type	Loans Modified as a TDR for the Three Months Ended June 30, 2017	
	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment
Commercial	1 \$ 5	\$ 5
Commercial real estate	—	—
Construction and land development	—	—
Home Equity	1 36	36
Residential real estate	—	—
Consumer	—	—
Total	2 \$ 41	\$ 41

Loan Type	Loans Modified as a TDR for the Six Months Ended June 30, 2017	
	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment
Commercial	3 \$ 73	\$ 73
Commercial real estate	—	—
Construction and land development	—	—
Home Equity	2 57	57
Residential real estate	—	—
Consumer	—	—
Total	5 \$ 130	\$ 130

The following tables show the detail of loans modified as TDRs during the three and six months ended June 30, 2016 included in the impaired loan balances (dollars in thousands):

Loan Type	Loans Modified as a TDR for the Three Months Ended June 30, 2016	
	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment
Commercial	1 \$ 24	\$ 24
Commercial real estate	1 937	937
Construction and land development	—	—
Home Equity	—	—
Residential real estate	1 2	1
Consumer	—	—
Total	3 \$ 963	\$ 962

Loan Type	Loans Modified as a TDR for the Six Months Ended June 30, 2016	
	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment
Commercial	1 \$ 24	\$ 24
Commercial real estate	2 1,005	1,003
Construction and land development	—	—
Home Equity	—	—
Residential real estate	1 2	1
Consumer	—	—
Total	4 \$ 1,031	\$ 1,028

During the three and six months ended June 30, 2017 and 2016, the Company had no loans that subsequently defaulted within twelve months of modification. The Company defines defaults as one or more payments that occur more than 90 days past the due date, charge-off or foreclosure subsequent to modification.

#### Residential Real Estate in Process of Foreclosure

The Company had \$1,127,000 in residential real estate loans in the process of foreclosure at June 30, 2017 and \$928,000 and \$653,000 in residential OREO at June 30, 2017 and December 31, 2016, respectively.

#### Risk Grades

The following table shows the Company's loan portfolio broken down by internal risk grading as of June 30, 2017 (dollars in thousands):

#### Commercial and Consumer Credit Exposure

##### Credit Risk Profile by Internally Assigned Grade

	Commercial	Construction and Land Development	Commercial Real Estate Other	Residential	Home Equity
Pass	\$ 235,653	\$ 128,538	\$ 580,241	\$ 198,350	\$ 111,640
Special Mention	367	2,072	4,126	8,771	1,339
Substandard	398	1,712	5,726	4,184	601
Doubtful	—	—	—	—	—
Total	\$ 236,418	\$ 132,322	\$ 590,093	\$ 211,305	\$ 113,580

#### Consumer Credit Exposure

##### Credit Risk Profile Based on Payment Activity

Consumer	
Performing	\$ 4,965
Nonperforming	10
Total	\$ 4,975

The following table shows the Company's loan portfolio broken down by internal risk grading as of December 31, 2016 (dollars in thousands):

Commercial and Consumer Credit Exposure

Credit Risk Profile by Internally Assigned Grade

	Commercial	Construction and Land Development	Commercial Real Estate Other	Residential	Home Equity
Pass	\$ 208,098	\$ 112,729	\$ 501,081	\$ 199,278	\$ 108,799
Special Mention	592	902	4,859	10,600	1,257
Substandard	27	627	5,020	5,226	695
Doubtful	—	—	—	—	—
Total	\$ 208,717	\$ 114,258	\$ 510,960	\$ 215,104	\$ 110,751

Consumer Credit Exposure

Credit Risk Profile Based on Payment Activity

Consumer

Performing	\$ 5,003
Nonperforming	28
Total	\$ 5,031

Loans classified in the Pass category typically are fundamentally sound and risk factors are reasonable and acceptable. Loans classified in the Special Mention category typically have been criticized internally, by loan review or the loan officer, or by external regulators under the current credit policy regarding risk grades.

Loans classified in the Substandard category typically have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt; they are typically characterized by the possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Loans classified in the Doubtful category typically have all the weaknesses inherent in loans classified as substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. However, these loans are not yet rated as loss because certain events may occur that may salvage the debt.

Consumer loans are classified as performing or nonperforming. A loan is nonperforming when payments of interest and principal are past due 90 days or more, or payments are less than 90 days past due, but there are other good reasons to doubt that payment will be made in full.

## Note 4 – Allowance for Loan Losses and Reserve for Unfunded Lending Commitments

Changes in the allowance for loan losses and the reserve for unfunded lending commitments as of the indicated dates and periods are presented below (dollars in thousands):

	Six Months Ended June 30, 2017	Year Ended December 31, 2016	Six Months Ended June 30, 2016
Allowance for Loan Losses			
Balance, beginning of period	\$12,801	\$ 12,601	\$12,601
Provision for loan losses	650	250	100
Charge-offs	(134 )	(326 )	(158 )
Recoveries	315	276	131
Balance, end of period	\$13,632	\$ 12,801	\$12,674

## Reserve for Unfunded Lending Commitments

Balance, beginning of period	\$203	\$ 184	\$184
Provision for unfunded commitments	4	19	12
Charge-offs	—	—	—
Balance, end of period	\$207	\$ 203	\$196

The reserve for unfunded loan commitments is included in other liabilities.

The following table presents changes in the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment at and for the six months ended June 30, 2017 (dollars in thousands):

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Total
Allowance for Loan Losses					
Balance at December 31, 2016:	\$ 2,095	\$ 7,355	\$ 3,303	\$ 48	\$12,801
Provision for loan losses	77	754	(203 )	22	650
Charge-offs	(23 )	(1 )	(24 )	(86 )	(134 )
Recoveries	212	15	22	66	315
Balance at June 30, 2017:	\$ 2,361	\$ 8,123	\$ 3,098	\$ 50	\$13,632

## Balance at June 30, 2017:

## Allowance for Loan Losses

Individually evaluated for impairment	\$ 5	\$ —	\$ 10	\$ —	\$15
Collectively evaluated for impairment	2,295	8,035	2,832	50	13,212
Acquired impaired loans	61	88	256	—	405
Total	\$ 2,361	\$ 8,123	\$ 3,098	\$ 50	\$13,632

## Loans

Individually evaluated for impairment	\$ 96	\$ 1,294	\$ 1,896	\$ 14	\$3,300
Collectively evaluated for impairment	235,899	707,480	310,028	4,946	1,258,353
Acquired impaired loans	423	13,641	12,961	15	27,040
Total	\$ 236,418	\$ 722,415	\$ 324,885	\$ 4,975	\$1,288,693

The following table presents changes in the Company's allowance for loan losses by portfolio segment and the related loan balance total by segment at and for the year ended December 31, 2016 (dollars in thousands):

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Total
Allowance for Loan Losses					
Balance at December 31, 2015:	\$ 2,065	\$ 6,930	\$ 3,546	\$ 60	\$ 12,601
Provision for loan losses	30	403	(224 )	41	250
Charge-offs	(40 )	(10 )	(87 )	(189 )	(326 )
Recoveries	40	32	68	136	276
Balance at December 31, 2016:	\$ 2,095	\$ 7,355	\$ 3,303	\$ 48	\$ 12,801

Balance at December 31, 2016:

Allowance for Loan Losses					
Individually evaluated for impairment	\$ —	\$ —	\$ 23	\$ —	\$ 23
Collectively evaluated for impairment	2,087	7,248	3,046	48	12,429
Acquired impaired loans	8	107	234	—	349
Total	\$ 2,095	\$ 7,355	\$ 3,303	\$ 48	\$ 12,801

Loans

Individually evaluated for impairment	\$ 43	\$ 2,186	\$ 2,588	\$ 27	\$ 4,844
Collectively evaluated for impairment	208,258	610,462	307,600	4,988	1,131,308
Acquired impaired loans	416	12,570	15,667	16	28,669
Total	\$ 208,717	\$ 625,218	\$ 325,855	\$ 5,031	\$ 1,164,821

The allowance for loan losses is allocated to loan segments based upon historical loss factors, risk grades on individual loans, portfolio analysis of smaller balance homogenous loans, and qualitative factors. Qualitative factors include trends in delinquencies, nonaccrual loans, and loss rates; trends in volume and terms of loans, effects of changes in risk selection, underwriting standards, and lending policies; experience of lending officers, other lending staff and loan review; national, regional, and local economic trends and conditions; legal, regulatory and collateral factors; and concentrations of credit.

#### Note 5 – Goodwill and Other Intangible Assets

The Company records as goodwill the excess of the purchase price over the fair value of the identifiable net assets acquired. Impairment testing is performed annually, as well as when an event triggering impairment may have occurred. The Company performs its annual analysis as of June 30 each fiscal year. Accounting guidance permits preliminary assessment of qualitative factors to determine whether more substantial impairment testing is required. The Company chose to bypass the preliminary assessment and utilized a two-step process for impairment testing of goodwill. The first step tests for impairment, while the second step, if necessary, measures the impairment. No indicators of impairment were identified as of June 30, 2017.

Core deposit intangibles resulting from the acquisition of MidCarolina Financial Corporation ("MidCarolina") in July 2011 were \$6,556,000 and are being amortized on an accelerated basis over 108 months. Core deposit intangibles resulting from the acquisition of MainStreet BankShares, Inc. ("MainStreet") in January 2015 were \$1,839,000 and are being amortized on an accelerated basis over 120 months.

The changes in the carrying amount of goodwill and intangibles for the six months ended June 30, 2017, are as follows (dollars in thousands):

	Goodwill	Intangibles
Balance at December 31, 2016	\$ 43,872	\$ 1,719
Additions	—	—
Amortization	—	(368 )
Impairment	—	—
Balance at June 30, 2017	\$ 43,872	\$ 1,351

Note 6 – Short-term Borrowings

Short-term borrowings consist of customer repurchase agreements, overnight borrowings from the FHLB, and Federal Funds purchased. The Company has federal funds lines of credit established with two correspondent banks in the amounts of \$15,000,000, each, and, additionally, has access to the FRB's discount window. Customer repurchase agreements are collateralized by securities of the U.S. Government or its agencies or GSEs. They mature daily. The interest rates may be changed at the discretion of the Company. The securities underlying these agreements remain under the Company's control. FHLB overnight borrowings contain floating interest rates that may change daily at the discretion of the FHLB. Federal funds purchased are unsecured overnight borrowings from other financial institutions. Short-term borrowings consisted of the following at June 30, 2017 and December 31, 2016 (dollars in thousands):

	June 30, 2017	December 31, 2016
Customer repurchase agreements	\$48,282	\$ 39,166
Other short-term borrowings	—	20,000
	\$48,282	\$ 59,166

Note 7 – Long-term Borrowings

Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans, second mortgage loans, home equity lines of credit, and commercial real estate loans. In addition, the Company pledges as collateral its capital stock in the FHLB and deposits with the FHLB. The Company has a line of credit with the FHLB equal to 30% of the Company's assets, subject to the amount of collateral pledged. As of June 30, 2017, \$467,616,000 in eligible collateral was pledged under the blanket floating lien agreement which covers both short-term and long-term borrowings.

Long-term borrowings consisted of the following fixed rate, long-term advances as of June 30, 2017 and December 31, 2016 (dollars in thousands):

Due by	June 30, 2017		December 31, 2016	
	Advance Amount	Weighted Average Rate	Due by	Weighted Average Rate
November 30, 2017	\$ 9,991	2.98 %	November 30, 2017	\$ 9,980 2.98 %

The advance due in November 2017 is net of a fair value discount of \$9,000. The original discount recorded on July 1, 2011, was a result of the merger with MidCarolina. The adjustment to the face value is being amortized into interest expense over the life of the borrowing. There were no long-term borrowings acquired in the MainStreet acquisition and no borrowings were incurred to fund the acquisition.

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the states of Virginia and North Carolina. At June 30, 2017, the Bank's public deposits totaled \$228,523,000. The Company is required to provide collateral to secure the deposits that exceed the insurance coverage provided by the Federal Deposit Insurance Corporation. This collateral can be provided in the form of certain types of government or agency bonds or letters of credit from the FHLB. At June 30, 2017, the Company had \$190,700,000 in letters of credit with the FHLB outstanding, as well as \$67,990,000 in agency, state, and municipal securities pledged to provide collateral

for such deposits.

22

---



#### Note 8 – Junior Subordinated Debt

On April 7, 2006, AMNB Statutory Trust I, a Delaware statutory trust and a wholly owned unconsolidated subsidiary of the Company, issued \$20,000,000 of preferred securities (the "Trust Preferred Securities") in a private placement pursuant to an applicable exemption from registration. The Trust Preferred Securities mature on June 30, 2036, but may be redeemed at the Company's option beginning on September 30, 2011. Distributions are cumulative and will accrue from the date of original issuance, but may be deferred by the Company from time to time for up to 20 consecutive quarterly periods. The Company has guaranteed the payment of all required distributions on the Trust Preferred Securities. The proceeds of the Trust Preferred Securities received by the trust, along with proceeds of \$619,000 received by the trust from the issuance of common securities by the trust to the Company, were used to purchase \$20,619,000 of the Company's junior subordinated debt securities (the "Junior Subordinated Debt"), issued pursuant to junior subordinated debentures entered into between the Company and Wilmington Trust Company, as trustee. The proceeds of the Junior Subordinated Debt were used to fund the cash portion of the merger consideration to the former shareholders of Community First Financial Corporation in connection with the Company's acquisition of that company in 2006, and for general corporate purposes.

On July 1, 2011, in connection with the MidCarolina merger, the Company assumed \$8,764,000 in junior subordinated debt to MidCarolina Trust I and MidCarolina Trust II, two separate Delaware statutory trusts (the "MidCarolina Trusts"), to fully and unconditionally guarantee the preferred securities issued by the MidCarolina Trusts. These long-term obligations, which currently qualify as Tier 1 capital, constitute a full and unconditional guarantee by the Company of the MidCarolina Trusts' obligations. The MidCarolina Trusts were not consolidated in the Company's financial statements.

In accordance with ASC 810-10-15-14, "Consolidation - Overall - Scope and Scope Exceptions," the Company did not eliminate through consolidation the Company's \$619,000 equity investment in AMNB Statutory Trust I or the \$264,000 equity investment in the MidCarolina Trusts. Instead, the Company reflected this equity investment in the "Accrued interest receivable and other assets" line item in the consolidated balance sheets.

A description of the junior subordinated debt securities outstanding payable to the trusts is shown below as of June 30, 2017 and December 31, 2016 (dollars in thousands):

Issuing Entity	Date Issued	Interest Rate	Maturity Date	Principal Amount	
				June 30, 2017	December 31, 2016
AMNB Trust I	4/7/2006	Libor plus 1.35%	6/30/2036	\$20,619	\$ 20,619
MidCarolina Trust I	10/29/2002	Libor plus 3.45%	11/7/2032	4,294	4,265
MidCarolina Trust II	12/3/2003	Libor plus 2.95%	10/7/2033	2,862	2,840
				\$27,775	\$ 27,724

The principal amounts reflected above for the MidCarolina Trusts are net of fair value adjustments of \$1,608,000 and \$1,659,000 at June 30, 2017 and December 31, 2016, respectively. The original fair value adjustments of \$1,197,000 and \$1,021,000 were recorded as a result of the acquisition of MidCarolina on July 1, 2011, and are being amortized into interest expense over the remaining lives of the respective borrowings.

#### Note 9 – Stock Based Compensation

The Company's 2008 Stock Incentive Plan ("2008 Plan") was adopted by the Board of Directors of the Company on February 19, 2008, and approved by shareholders on April 22, 2008, at the Company's 2008 Annual Meeting of Shareholders. The 2008 Plan provides for the granting of restricted stock awards and incentive and non-statutory options to employees and directors on a periodic basis, at the discretion of the Board of Directors or a Board designated committee. The 2008 Plan authorizes the issuance of up to 500,000 shares of common stock. The 2008 Plan replaced the Company's stock option plan that was approved by the shareholders at the 1997 Annual Meeting, which expired in 2006.

#### Stock Options

Accounting guidance requires that compensation cost relating to share-based payment transactions be recognized in the financial statements with measurement based upon the fair value of the equity or liability instruments issued.

A summary of stock option transactions for the six months ended June 30, 2017 is as follows:

	Option Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (\$000)
Outstanding at December 31, 2016	58,411	\$ 24.37		
Acquired in acquisition	—	—		
Granted	—	—		
Exercised	(3,300)	21.97		
Forfeited	(578)	23.33		
Expired	(1,320)	41.67		
Outstanding at June 30, 2017	53,213	\$ 24.10	1.28 years	\$ 684
Exercisable at June 30, 2017	53,213	\$ 24.10	1.28 years	\$ 684

The fair value of options is estimated at the date of grant using the Black-Scholes option pricing model and expensed over the options' vesting period. No stock options have been granted since 2009. As of June 30, 2017, there were no unrecognized compensation expenses related to nonvested stock option grants.

#### Restricted Stock

The Company from time-to-time grants shares of restricted stock to key employees and non-employee directors. These awards help align the interests of these employees and directors with the interests of the shareholders of the Company by providing economic value directly related to increases in the value of the Company's common stock. The value of the stock awarded is established as the fair value of the stock at the time of the grant. The Company recognizes expense, equal to the total value of such awards, ratably over the vesting period of the stock grants. The majority of the restricted stock granted in 2016 and 2017 cliff vests at the end of a 36 month period beginning on the date of the grant. The remainder vests a third each year beginning on the date of the grant. Nonvested restricted stock activity for the six months ended June 30, 2017 is summarized in the following table.

Restricted Stock	Shares	Weighted Average Grant Date Value
Nonvested at December 31, 2016	50,822	\$ 23.21
Granted	14,453	34.74
Vested	(17,126)	24.21
Forfeited	—	—
Nonvested at June 30, 2017	48,149	\$ 26.32

As of June 30, 2017 and December 31, 2016, there was \$765,000 and \$568,000, respectively, in unrecognized compensation cost related to nonvested restricted stock granted under the 2008 Plan. The weighted average period over which this cost is expected to be recognized is 1.54 years. The share based compensation expense for nonvested restricted stock was \$304,000 and \$153,000 during the first six months of 2017 and 2016, respectively.

Starting in 2010, the Company began offering its outside directors alternatives with respect to director compensation. The regular quarterly board retainer can be received in the form of either (a) \$5,800 in cash or (b) shares of immediately vested, but restricted stock with a market value of \$6,250. Monthly meeting fees can also be received as \$725 per meeting in cash or \$900 in immediately vested, but restricted stock. For 2017, all 12 outside directors have elected to receive stock in lieu of cash for either all or part of their monthly retainer board fees. Only outside directors receive board fees. The Company issued 7,109 and 7,451 shares and recognized share based compensation expense of \$255,000 and \$198,000 during the first six months of 2017 and 2016, respectively.

## Note 10 – Earnings Per Common Share

The following shows the weighted average number of shares used in computing earnings per common share and the effect on weighted average number of shares of potentially dilutive common stock. Potentially dilutive common stock had no effect on income available to common shareholders. Nonvested restricted shares are included in the computation of basic earnings per share as the holder is entitled to full shareholder benefits during the vesting period including voting rights and sharing in nonforfeitable dividends. The following table presents basic and diluted earnings per share for the three and six month periods ended June 30, 2017 and 2016.

	Three Months Ended June 30,			
	2017		2016	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	8,640,648	\$ 0.50	8,610,156	\$ 0.47
Effect of dilutive securities - stock options	18,517	(0.01 )	9,677	—
Diluted earnings per share	8,659,165	\$ 0.49	8,619,833	\$ 0.47
	Six Months Ended June 30,			
	2017		2016	
	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	8,636,954	\$ 0.97	8,610,998	\$ 0.95
Effect of dilutive securities - stock options	18,219	(0.01 )	5,875	—
Diluted earnings per share	8,655,173	\$ 0.96	8,616,873	\$ 0.95

Outstanding stock options on common stock that were not included in computing diluted earnings per share for the six month periods ended June 30, 2017 and 2016 because their effects were anti-dilutive, averaged 660 and 30,571 shares, respectively.

## Note 11 – Employee Benefit Plans

The following information for the six months ended June 30, 2017 and 2016 pertains to the Company's non-contributory defined benefit pension plan which was frozen in 2009. If lump sum payments exceed the service cost plus interest cost, an additional settlement charge will apply (dollars in thousands):

Components of Net Periodic Benefit Cost	Six Months Ended June 30,	
	2017	2016
Service cost	\$—	\$—
Interest cost	118	134
Expected return on plan assets	(177 )	(192)
Recognized loss due to settlement	70	114
Recognized net actuarial loss	109	—
Net periodic cost	\$120	\$56

## Note 12 – Fair Value of Financial Instruments

### Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the fair value measurements and disclosures topic of FASB ASC 820, the fair value of an instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

### Fair Value Hierarchy

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 – Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 – Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 – Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by the Company to measure certain financial assets and financial liabilities recorded at fair value on a recurring basis in the financial statements:

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). If no observable market data is available, valuations are based upon third party model based techniques (Level 3). There were no securities recorded with a Level 3 valuation at June 30, 2017 or December 31, 2016.

The following table presents the balances of financial assets measured at fair value on a recurring basis at the dates indicated (dollars in thousands):

Fair Value Measurements at June 30, 2017				
Using				
Description	Balance at June 30, 2017	Quoted	Significant	Significant
		Prices in Active Markets for Identical Assets	Other Observable Inputs	Unobservable Inputs
		Level 1	Level 2	Level 3
Assets:				
Securities available for sale:				
Federal agencies and GSEs	\$91,692	\$ —	—\$ 91,692	\$ —
Mortgage-backed and CMOs	79,068	—	79,068	—
State and municipal	99,205	—	99,205	—
Corporate	8,315	—	8,315	—
Equity securities	2,223	—	2,223	—
Total	\$280,503	\$ —	—\$ 280,503	\$ —
Fair Value Measurements at December 31, 2016				
Using				
Description	Balance at December 31, 2016	Quoted	Significant	Significant
		Prices in Active Markets for Identical Assets	Other Observable Inputs	Unobservable Inputs
		Level 1	Level 2	Level 3
Assets:				
Securities available for sale:				
Federal agencies and GSEs	\$104,054	\$ —	—\$ 104,054	\$ —
Mortgage-backed and CMOs	79,493	—	79,493	—
State and municipal	147,515	—	147,515	—
Corporate	13,492	—	13,492	—
Equity securities	1,948	—	1,498	—
Total	\$346,502	\$ —	—\$ 346,052	\$ —

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Company to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements:

**Loans held for sale:** Loans held for sale are carried at fair value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the six month

period ended June 30, 2017 or the year ended December 31, 2016. Gains and losses on the sale of loans are recorded within mortgage banking income on the Consolidated Statements of Income.

Impaired loans: Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreements will not be collected when due. The measurement of the loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Company's collateral is real estate. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal, of one year or less, conducted by an independent, licensed appraiser using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than one year old and not solely based on observable market comparables

or management determines the fair value of the collateral is further impaired below the appraised value, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

OREO: Measurement for fair values for OREO are the same as impaired loans. Any fair value adjustments are recorded in the period incurred as a valuation allowance against other real estate owned with the associated expense included in other real estate owned expense, net on the Consolidated Statements of Income.

The following table summarizes the Company's assets that were measured at fair value on a nonrecurring basis at the dates indicated (dollars in thousands):

Description	Fair Value Measurements at June 30, 2017			
	Using	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
	Balance at June 30, 2017	Level 1	Level 2	Level 3
Assets:				
Loans held for sale	\$2,379	\$ —	—\$ 2,379	\$ —
Impaired loans, net of valuation allowance	1,534	—	—	1,534
Other real estate owned, net	1,686	—	—	1,686

Description	Fair Value Measurements at December 31, 2016			
	Using	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
	Balance at December 31, 2016	Level 1	Level 2	Level 3
Assets:				
Loans held for sale	\$5,996	\$ —	—\$ 5,996	\$ —
Impaired loans, net of valuation allowance	2,151	—	—	2,151
Other real estate owned, net	1,328	—	—	1,328

The following tables summarize the Company's quantitative information about Level 3 fair value measurements at the dates indicated:

Quantitative Information About Level 3 Fair Value Measurements at June 30, 2017			
Assets	Valuation Technique	Unobservable Input	Weighted Rate
Impaired loans	Discounted appraised value	Selling cost	8 %
Other real estate owned, net	Discounted appraised value	Selling cost	8 %



Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-Q

Quantitative Information About Level 3 Fair Value Measurements at December 31, 2016

Assets	Valuation Technique	Unobservable Input	Weighted Rate
Impaired loans	Discounted appraised value	Selling cost	8 %
Other real estate owned, net	Discounted appraised value	Selling cost	6 %

28

---

ASC 825, "Financial Instruments," requires disclosure about fair value of financial instruments for interim periods and excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company. The carrying values and estimated fair values of the Company's financial instruments at June 30, 2017 are as follows (dollars in thousands):

## Fair Value Measurements at June 30, 2017 Using

	Carrying Value	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value Balance
<b>Financial Assets:</b>					
Cash and cash equivalents	\$85,929	\$85,929	\$—	\$ —	\$85,929
Securities available for sale	280,503	—	280,503	—	280,503
Restricted stock	5,501	—	5,501	—	5,501
Loans held for sale	2,379	—	2,379	—	2,379
Loans, net of allowance	1,275,061	—	—	1,276,921	1,276,921
Bank owned life insurance	18,381	—	18,381	—	18,381
Accrued interest receivable	4,820	—	4,820	—	4,820
<b>Financial Liabilities:</b>					
Deposits	\$1,462,841	\$—	\$1,073,660	\$ 385,502	\$1,459,162
Repurchase agreements	48,282	—	48,282	—	48,282
Long-term borrowings	9,991	—	—	10,052	10,052
Junior subordinated debt	27,775	—	—	27,403	27,403
Accrued interest payable	611	—	611	—	611

The carrying values and estimated fair values of the Company's financial instruments at December 31, 2016 are as follows (dollars in thousands):

	Fair Value Measurements at December 31, 2016 Using				
	Carrying Value	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Fair Value
	Level 1	Level 2	Level 3	Balance	
<b>Financial Assets:</b>					
Cash and cash equivalents	\$53,207	\$53,207	\$—	\$—	\$53,207
Securities available for sale	346,502	—	346,502	—	346,502
Restricted stock	6,224	—	6,224	—	6,224
Loans held for sale	5,996	—	5,996	—	5,996
Loans, net of allowance	1,152,020	—	—	1,136,961	1,136,961
Bank owned life insurance	18,163	—	18,163	—	18,163
Accrued interest receivable	5,083	—	5,083	—	5,083
<b>Financial Liabilities:</b>					
Deposits	\$1,370,640	\$—	\$991,785	\$374,774	\$1,366,559
Repurchase agreements	39,166	—	39,166	—	39,166
Other short-term borrowings	20,000	—	20,000	—	20,000
Long-term borrowings	9,980	—	—	10,156	10,156
Junior subordinated debt	27,724	—	—	24,932	24,932
Accrued interest payable	623	—	623	—	623

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments:

Cash and cash equivalents. The carrying amount is a reasonable estimate of fair value.

Securities. Fair values are based on quoted market prices or dealer quotes.

Restricted stock. The carrying value of restricted stock approximates fair value based on the redemption provisions of the respective entity.

Loans held for sale. The carrying amount is at fair value. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale.

Loans. For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed-rate loans are estimated based upon discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for nonperforming loans are estimated using discounted cash flow analysis or underlying collateral values, where applicable.

Bank owned life insurance. Bank owned life insurance represents insurance policies on officers, directors, and past directors of the Company. The cash values of the policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

Accrued interest receivable. The carrying amount is a reasonable estimate of fair value.

Deposits. The fair value of demand deposits, savings deposits, and money market deposits equals the carrying value. The fair value of fixed-rate certificates of deposit is estimated by discounting the future cash flows using the current rates at which similar deposit instruments would be offered to depositors for the same remaining maturities.

Repurchase agreements. The carrying amount is a reasonable estimate of fair value.

Other short-term borrowings. The carrying amount is a reasonable estimate of fair value.

Long-term borrowings. The fair values of long-term borrowings are estimated using discounted cash flow analysis based on the interest rates for similar types of borrowing arrangements.

Junior subordinated debt. Fair value is calculated by discounting the future cash flows using the estimated current interest rates at which similar securities would be issued.

Accrued interest payable. The carrying amount is a reasonable estimate of fair value.

Off-balance sheet instruments. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At June 30, 2017 and December 31, 2016, the fair value of off-balance sheet instruments was deemed immaterial, and therefore was not included in the previous table.

The Company assumes interest rate risk (the risk that interest rates will change) in its normal operations. As a result, the fair values of the Company's financial instruments will change when interest rates change and that change may be either favorable or unfavorable to the Company.

#### Note 13 – Segment and Related Information

The Company has two reportable segments, community banking and trust and investment services.

Community banking involves making loans to and generating deposits from individuals and businesses. All assets and liabilities of the Company are allocated to community banking. Investment income from securities is also allocated to the community banking segment. Loan fee income, service charges from deposit accounts, and non-deposit fees such as automated teller machine fees and insurance commissions generate additional income for the community banking segment.

Trust and investment services include estate planning, trust account administration, investment management, and retail brokerage. Investment management services include purchasing equity, fixed income, and mutual fund investments for customer accounts. The trust and investment services segment receives fees for investment and administrative services.

Amounts shown in the "Other" column includes activities of the Company which are primarily debt service on trust preferred securities and corporate items.

Segment information as of and for the three and six months ended June 30, 2017 and 2016 (unaudited), is shown in the following tables (dollars in thousands):

	Three Months Ended June 30, 2017				
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	\$ 15,518	\$ —	—\$ 85	\$ —	\$ 15,603
Interest expense	1,447	—	244	—	1,691
Noninterest income	2,242	1,100	6	—	3,348
Income (loss) before income taxes	6,129	518	(448 )	—	6,199
Net income (loss)	4,217	358	(296 )	—	4,279
Depreciation and amortization	669	3	—	—	672
Total assets	1,755,185	—	234,913	(225,625)	1,764,473
Goodwill	43,872	—	—	—	43,872
Capital expenditures	1,071	5	—	—	1,076

	Three Months Ended June 30, 2016				Total
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	
Interest income	\$13,754	\$ —	—\$ 15	\$ —	\$ 13,769
Interest expense	1,396	—	213	—	1,609
Noninterest income	2,177	1,184	6	—	3,367
Income (loss) before income taxes	5,566	679	(424 )	—	5,821
Net income (loss)	3,891	477	(280 )	—	4,088
Depreciation and amortization	759	3	—	—	762
Total assets	1,597,722	—	230,456	(226,527)	1,601,651
Goodwill	43,872	—	—	—	43,872
Capital expenditures	120	—	—	—	120
	Six Months Ended June 30, 2017				Total
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	
Interest income	\$30,114	\$ —	—\$ 170	\$ —	\$ 30,284
Interest expense	2,755	—	483	—	3,238
Noninterest income	4,403	2,204	12	—	6,619
Income (loss) before income taxes	11,586	1,059	(782 )	—	11,863
Net income (loss)	8,113	746	(517 )	—	8,342
Depreciation and amortization	1,275	6	—	—	1,281
Total assets	1,755,185	—	234,913	(225,625)	1,764,473
Goodwill	43,872	—	—	—	43,872
Capital expenditures	1,728	11	—	—	1,739
	Six Months Ended June 30, 2016				Total
	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	
Interest income	\$27,910	\$ —	—\$ 30	\$ —	\$ 27,940
Interest expense	2,775	—	421	—	3,196
Noninterest income	4,335	2,318	11	—	6,664
Income (loss) before income taxes	11,182	1,334	(782 )	—	11,734
Net income (loss)	7,798	934	(516 )	—	8,216
Depreciation and amortization	1,519	6	—	—	1,525
Total assets	1,597,722	—	230,456	(226,527)	1,601,651
Goodwill	43,872	—	—	—	43,872
Capital expenditures	269	—	—	—	269

## Note 14 – Supplemental Cash Flow Information

	Six Months Ended June 30, 2017    2016	
Supplemental Schedule of Cash and Cash Equivalents:		
Cash and due from banks	\$23,765	\$21,625
Interest-bearing deposits in other banks	62,164	51,716
Cash and Cash Equivalents	\$85,929	\$73,341

## Supplemental Disclosure of Cash Flow Information:

## Cash paid for:

Interest on deposits and borrowed funds	\$3,250	\$3,183
Income taxes	3,707	3,397

## Noncash investing and financing activities:

Transfer of loans to other real estate owned	513	97
Unrealized gains on securities available for sale	1,300	2,217

## Note 15 – Accumulated Other Comprehensive Income

Changes in each component of accumulated other comprehensive income ("AOCI") for the three and six months ended June 30, 2017 and 2016 (unaudited) were as follows (dollars in thousands):

For the Three Months Ended	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Income (Loss)
Balance at March 31, 2016	\$ 5,328	\$ (1,832 )	\$ 3,496
Net unrealized gains on securities available for sale, net of tax, \$204	379	—	379
Reclassification adjustment for realized gains on securities, net of tax, \$(78)	(144 )	—	(144 )
Balance at June 30, 2016	\$ 5,563	\$ (1,832 )	\$ 3,731
Balance at March 31, 2017	\$ 339	\$ (1,724 )	\$ (1,385 )
Net unrealized gains on securities available for sale, net of tax, \$307	572	—	572
Reclassification adjustment for realized gains on securities, net of tax, \$(116)	(215 )	—	(215 )
Balance at June 30, 2017	\$ 696	\$ (1,724 )	\$ (1,028 )

For the Six Months Ended	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension Benefits	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2015	\$ 4,122	\$ (1,832 )	\$ 2,290
Net unrealized gains on securities available for sale, net of tax, \$982	1,823	—	1,823
Reclassification adjustment for realized gains on securities, net of tax, \$(206)	(382 )	—	(382 )
Balance at June 30, 2016	\$ 5,563	\$ (1,832 )	\$ 3,731
Balance at December 31, 2016	\$ (150 )	\$ (1,724 )	\$ (1,874 )
Net unrealized gains on securities available for sale, net of tax, \$661	1,229	—	1,229
Reclassification adjustment for gains on sales of securities, net of tax, \$(207)	(383 )	—	(383 )
Balance at June 30, 2017	\$ 696	\$ (1,724 )	\$ (1,028 )

Reclassifications Out of Accumulated Other Comprehensive Income  
For the three and six months ended June 30, 2017 and 2016  
(dollars in thousands)

For the Three Months Ended June 30, 2017	Amount Reclassified from AOCI	Affected Line Item in the Statement of Where Net Income is Presented
Details about AOCI Components		
Available for sale securities:		
Realized gain on sale of securities	\$ 331	Securities gains, net
	(116 )	Income taxes
Total reclassifications	\$ 215	Net of tax
For the Three Months Ended June 30, 2016	Amount Reclassified from AOCI	Affected Line Item in the Statement of Where Net Income is Presented
Details about AOCI Components		
Available for sale securities:		
Realized gain on sale of securities	\$ 222	Securities gains, net
	(78 )	Income taxes
Total reclassifications	\$ 144	Net of tax



For the Six Months Ended June 30, 2017	Amount Reclassified from AOCI	Affected Line Item in the Statement of Where Net Income is Presented
Details about AOCI Components		
Available for sale securities:		
Realized gain on sale of securities	\$ 590	Securities gains, net
	(207 )	Income taxes
Total reclassifications	\$ 383	Net of tax
For the Six Months Ended June 30, 2016		
Details about AOCI Components		
Available for sale securities:		
Realized gain on sale of securities	\$ 588	Securities gains, net
	(206 )	Income taxes
Total reclassifications	\$ 382	Net of tax

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The purpose of this discussion is to focus on important factors affecting the financial condition and results of operations of the Company. The discussion and analysis should be read in conjunction with the Consolidated Financial Statements.

#### Forward-Looking Statements

This report contains forward-looking statements with respect to the financial condition, results of operations and business of American National Bankshares Inc. (the "Company") and its wholly owned subsidiary, American National Bank and Trust Company (the "Bank"). These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management of the Company and on information available to management at the time these statements and disclosures were prepared. Forward-looking statements are subject to numerous assumptions, estimates, risks, and uncertainties that could cause actual conditions, events, or results to differ materially from those stated or implied by such forward-looking statements.

A variety of factors, some of which are discussed in more detail in Item 1A – Risk Factors of the Company's Annual Report on Form 10-K for the year ended December 31, 2016, may affect the operations, performance, business strategy, and results of the Company. Those factors include, but are not limited to, the following:

- Financial market volatility, including the level of interest rates, could affect the values of financial instruments and the amount of net interest income earned;

- General economic or business conditions, either nationally or in the market areas in which the Company does business, may be less favorable than expected, resulting in deteriorating credit quality, reduced demand for credit, or a weakened ability to generate deposits;

- Competition among financial institutions may increase, and competitors may have greater financial resources and develop products and technology that enable those competitors to compete more successfully than the Company;

- Businesses that the Company is engaged in may be adversely affected by legislative or regulatory changes, including changes in accounting standards;

- The ability to retain key personnel;

- The failure of assumptions underlying the allowance for loan losses; and

- Risks associated with mergers and acquisitions and other expansion activities.

#### Reclassification

In certain circumstances, reclassifications have been made to prior period information to conform to the 2017 presentation. There were no material reclassifications.



## CRITICAL ACCOUNTING POLICIES

The accounting and reporting policies followed by the Company conform with U.S. generally accepted accounting principles ("GAAP") and they conform to general practices within the banking industry. The Company's critical accounting policies, which are summarized below, relate to (1) the allowance for loan losses, (2) mergers and acquisitions, (3) acquired loans with specific credit-related deterioration (4) goodwill and intangible assets, (5) other real estate owned, (6) deferred tax assets and liabilities, (7) other-than-temporary impairment of securities and (8) the unfunded pension liability. A summary of the Company's significant accounting policies is set forth in Note 1 to the Consolidated Financial Statements contained in the Form 10-K for the year ended December 31, 2016.

The financial information contained within the Company's financial statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained when earning income, recognizing an expense, recovering an asset, or relieving a liability. In addition, GAAP itself may change from one previously acceptable method to another method.

### Allowance for Loan Losses

The purpose of the allowance for loan losses ("ALLL") is to provide for probable losses inherent in the loan portfolio. The allowance is increased by the provision for loan losses and by recoveries of previously charged-off loans. Loan charge-offs decrease the allowance.

The goal of the Company is to maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and the provision for loan loss expense.

The Company uses certain practices to manage its credit risk. These practices include (1) appropriate lending limits for loan officers, (2) a loan approval process, (3) careful underwriting of loan requests, including analysis of borrowers, cash flows, collateral, and market risks, (4) regular monitoring of the portfolio, including diversification by type and geography, (5) review of loans by the Loan Review department, which operates independently of loan production, (6) regular meetings of the Credit Committee to discuss portfolio and policy changes and make decisions on large or unusual loan requests, and (7) regular meetings of the Asset Quality Committee which reviews the status of individual loans.

Risk grades are assigned as part of the loan origination process. From time to time, risk grades may be modified as warranted by the facts and circumstances surrounding the credit.

Calculation and analysis of the ALLL is prepared quarterly by the Finance Department. The Company's Credit Committee, Risk and Compliance Committee, Audit Committee, and the Board of Directors review the allowance for adequacy.

The Company's ALLL has two basic components: the formula allowance and the specific allowance. Each of these components is determined based upon estimates and judgments.

The formula allowance uses historical loss experience as an indicator of future losses, along with various qualitative factors, including levels and trends in delinquencies, nonaccrual loans, charge-offs and recoveries, trends in volume and terms of loans, effects of changes in underwriting standards, experience of lending staff, economic conditions, portfolio concentrations, regulatory, legal, competition, quality of loan review system, and value of underlying collateral. In the formula allowance for commercial and commercial real estate loans, the historical loss rate is combined with the qualitative factors, resulting in an adjusted loss factor for each risk-grade category of loans. The period-end balances for each loan risk-grade category are multiplied by the adjusted loss factor. Allowance calculations for residential real estate and consumer loans are calculated based on historical losses for each product category without regard to risk grade. This loss rate is combined with qualitative factors resulting in an adjusted loss factor for each product category.

The specific allowance uses various techniques to arrive at an estimate of loss for specifically identified impaired loans. These include:

The present value of expected future cash flows discounted at the loan's effective interest rate. The effective interest rate on a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs and any premium or discount existing at the origination or acquisition of the loan);

• The loan's observable market price, or

The fair value of the collateral, net of estimated costs to dispose, if the loan is collateral dependent. The use of these computed values is inherently subjective and actual losses could be greater or less than the estimates. No single statistic, formula, or measurement determines the adequacy of the allowance. Management makes subjective and complex judgments about matters that are inherently uncertain, and different amounts would be reported under different

conditions or using different assumptions. For analytical purposes, management allocates a portion of the allowance to specific loan categories and specific loans. However, the entire allowance is used to absorb credit losses inherent in the loan portfolio, including identified and unidentified losses.

The relationships and ratios used in calculating the allowance, including the qualitative factors, may change from period to period as facts and circumstances evolve. Furthermore, management cannot provide assurance that in any particular period the Bank will not have sizable credit losses in relation to the amount reserved. Management may find it necessary to significantly adjust the allowance, considering current factors at the time.

#### Mergers and Acquisitions

Business combinations are accounted for under the Financial Accounting Standards Board (the "FASB") Accounting Standards Codification ("ASC") 805, Business Combinations, using the acquisition method of accounting. The acquisition method of accounting requires an acquirer to recognize the assets acquired and the liabilities assumed at the acquisition date measured at their fair values as of that date. To determine the fair values, the Company will rely on third party valuations, such as appraisals, or internal valuations based on discounted cash flow analysis or other valuation techniques. Under the acquisition method of accounting, the Company will identify the acquirer and the closing date and apply applicable recognition principles and conditions.

Acquisition-related costs are costs the Company incurs to effect a business combination. Those costs include advisory, legal, accounting, valuation, and other professional or consulting fees. Some other examples of costs to the Company include systems conversions, integration planning consultants and advertising costs. The Company will account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities will be recognized in accordance with other applicable GAAP. These acquisition-related costs have been and will be included within the Consolidated Statements of Income classified within the noninterest expense caption.

#### Acquired Loans with Specific Credit-Related Deterioration

Acquired loans with specific credit deterioration are accounted for by the Company in accordance with FASB ASC 310-30, Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality. Certain acquired loans, those for which specific credit-related deterioration, since origination, is identified, are recorded at fair value reflecting the present value of the amounts expected to be collected. Income recognition on these loans is based on a reasonable expectation about the timing and amount of cash flows to be collected. Acquired loans deemed impaired and considered collateral dependent, with the timing of the sale of loan collateral indeterminate, remain on non-accrual status and have no accretible yield.

#### Goodwill and Intangible Assets

The Company performs its annual analysis as of June 30 each fiscal year. Accounting guidance permits preliminary assessment of qualitative factors to determine whether more substantial impairment testing is required. The Company chose to bypass the preliminary assessment and utilized a two-step process for impairment testing of goodwill. The first step tests for impairment, while the second step, if necessary, measures the impairment. No indicators of impairment were identified during the six months ended June 30, 2017 or 2016.

#### Other Real Estate Owned

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less costs to sell at the date of foreclosure. Subsequent to foreclosure, management periodically performs valuations of the foreclosed assets based on updated appraisals, general market conditions, recent sales of similar properties, length of time the properties have been held, and our ability and intention with regard to continued ownership of the properties. The Company may incur additional write-downs of foreclosed assets to fair value less costs to sell if valuations indicate a further deterioration in market conditions.

#### Deferred Tax Assets and Liabilities

The realization of deferred income tax assets is assessed and a valuation allowance is recorded if it is "more likely than not" that all or a portion of the deferred tax asset will not be realized. "More likely than not" is defined as greater than a 50% chance. Management considers all available evidence, both positive and negative, to determine whether, based on the weight of that evidence, a valuation allowance is needed.



#### Other-than-temporary Impairment of Securities

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (1) the Company intends to sell the security or (2) it is more-likely-than-not that the Company will be required to sell the security before recovery of its amortized cost basis. If, however, the Company does not intend to sell the security and it is not more-likely-than-not that it will be required to sell the security before recovery, the Company must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost basis of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists, and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income. For equity securities, impairment is considered to be other-than-temporary based on the Company's ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in net income. The Company regularly reviews each investment security for other-than-temporary impairment based on criteria that includes the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the Company's best estimate of the present value of cash flows expected to be collected from debt securities, the Company's intention with regard to holding the security to maturity and the likelihood that the Company would be required to sell the security before recovery.

#### Unfunded Pension Liability

The Company previously maintained a non-contributory, defined benefit pension plan for eligible full-time employees as specified by the plan. The Company froze its pension plan to new participants and converted its pension plan to a cash balance plan effective December 31, 2009. Plan assets, which consist primarily of mutual funds invested in marketable equity securities and corporate and government fixed income securities, are valued using market quotations. The Company's actuary determines plan obligations and annual pension expense using a number of key assumptions. Key assumptions may include the discount rate, the interest crediting rate, the estimated future return on plan assets and the anticipated rate of future salary increases. Changes in these assumptions in the future, if any, or in the method under which benefits are calculated may impact pension assets, liabilities or expense.

#### Non-GAAP Presentations

Non-GAAP presentations are provided because the Company believes these may be valuable to investors. These include (1) the analysis of net interest income presented on a taxable equivalent basis to facilitate performance comparisons among various taxable and tax-exempt assets and (2) the calculation of the efficiency ratio.

#### Internet Access to Corporate Documents

The Company provides access to its Securities and Exchange Commission ("SEC") filings through a link on the Investor Relations page of the Company's web site at [www.amnb.com](http://www.amnb.com). Reports available include annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are filed electronically with the SEC. The information on the Company's website is not incorporated into this report or any other filing the Company makes with the SEC. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov).

#### STRATEGIC EVENT

The Company announced in September 2016 its plan to form a de novo branch in each of Roanoke, Virginia, and Winston-Salem, North Carolina. Current staffing for Roanoke includes 16 full-time equivalent employees, of which eight are lenders. Current staffing for Winston-Salem includes six full-time equivalent employees, of which three are lenders. The operations of these new branches impacted earning assets, deposits and operating results for the first and second quarters of 2017.

It is expected that the de novo efforts will have a continued material and positive impact to the Company's balance sheet and earnings, however, at a somewhat reduced pace over the next several quarters.





## RESULTS OF OPERATIONS

## Earnings Performance

Three months ended June 30, 2017 and 2016

For the quarter ended June 30, 2017, the Company reported net income of \$4,279,000 compared to \$4,088,000 for the comparable quarter in 2016. The \$191,000 or 4.7% increase was driven primarily by growth in loans.

## SUMMARY INCOME STATEMENT

(Dollars in thousands)

Three Months Ended June 30,	2017	2016	\$	%
			Change	Change
Interest income	\$15,603	\$13,769	\$1,834	13.3 %
Interest expense	(1,691 )	(1,609 )	(82 )	5.1
Net interest income	13,912	12,160	1,752	14.4
Provision for loan losses	(350 )	(50 )	(300 )	600.0
Noninterest income	3,348	3,367	(19 )	(0.6 )
Noninterest expense	(10,711 )	(9,656 )	(1,055 )	10.9
Income tax expense	(1,920 )	(1,733 )	(187 )	10.8
Net income	\$4,279	\$4,088	\$191	4.7

Six months ended June 30, 2017 and 2016

For the six month period ended June 30, 2017, the Company reported net income of \$8,342,000 compared to \$8,216,000 for the comparable period in 2016. The \$126,000 or 1.5% increase was driven primarily by growth in loans.

## SUMMARY INCOME STATEMENT

(Dollars in thousands)

Six Months Ended June 30,	2017	2016	\$	%
			Change	Change
Interest income	\$30,284	\$27,940	\$2,344	8.4 %
Interest expense	(3,238 )	(3,196 )	(42 )	1.3
Net interest income	27,046	24,744	2,302	9.3
Provision for loan losses	(650 )	(100 )	(550 )	550.0
Noninterest income	6,619	6,664	(45 )	(0.7 )
Noninterest expense	(21,152 )	(19,574 )	(1,578 )	8.1
Income tax expense	(3,521 )	(3,518 )	(3 )	0.1
Net income	\$8,342	\$8,216	\$126	1.5

## Net Interest Income

Net interest income is the difference between interest income on earning assets, primarily loans and securities, and interest expense on interest bearing liabilities, primarily deposits and other funding sources. Fluctuations in interest rates as well as volume and mix changes in earning assets and interest bearing liabilities can materially impact net interest income. The following discussion of net interest income is presented on a taxable equivalent basis to facilitate performance comparisons among various taxable and tax-exempt assets, such as certain state and municipal securities. A tax rate of 35% was used in adjusting interest on tax-exempt assets to a fully taxable equivalent basis. Net interest income divided by average earning assets is referred to as the net interest margin. The net interest spread represents the difference between the average rate earned on earning assets and the average rate paid on interest-bearing liabilities.



Three months ended June 30, 2017 and 2016

Net interest income on a taxable equivalent basis increased \$1,611,000 or 12.7%, for the second quarter of 2017 compared to the same quarter of 2016. The increase was primarily due to increased loan volume in the 2017 quarter compared to the 2016 quarter.

For the second quarter of 2017, the Company's yield on interest-earning assets was 3.96%, compared to 3.89% for the second quarter of 2016. The cost of interest-bearing liabilities was 0.60% compared to 0.61%, primarily related to a two basis point decrease in the cost of deposits. The interest rate spread was 3.36% compared to 3.28%. The net interest margin, on a fully taxable equivalent basis, was 3.54% compared to 3.45%, an increase of nine basis points (0.09%). The increase in net interest margin was driven by larger volumes in earning assets, fueled by a \$62.9 million or 19.5% increase in non-interest bearing deposits, and a slight decrease in the cost of interest bearing liabilities. The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the three months ended June 30, 2017 and 2016. Nonaccrual loans are included in average balances. Interest income on nonaccrual loans, if recognized, is recorded on a cash basis or when the loan returns to accrual status.

40

---

Net Interest Income Analysis (dollars in thousands)  
Three Months Ended June 30,

	Average Balance		Income/Expense		Yield/Rate	
	2017	2016	2017	2016	2017	2016
<b>Loans:</b>						
Commercial	\$229,690	\$200,000	\$2,241	\$1,976	3.91%	3.97%
Real estate	1,026,010	844,914	11,502	9,591	4.48	4.54
Consumer	5,072	5,166	89	140	7.04	10.90
Total loans	1,260,772	1,050,080	13,832	11,707	4.39	4.46
<b>Securities:</b>						
Federal agencies and GSEs	96,339	100,205	454	446	1.89	1.78
Mortgage-backed and CMOs	80,003	81,379	412	425	2.06	2.09
State and municipal	104,115	164,788	938	1,472	3.60	3.57
Other securities	15,406	14,692	179	130	4.65	3.54
Total securities	295,863	361,064	1,983	2,473	2.68	2.74
Deposits in other banks	53,497	53,548	125	67	0.94	0.50
Total interest-earning assets	1,610,132	1,464,692	15,940	14,247	3.96	3.89
Non-earning assets	126,554	127,569				
Total assets	\$1,736,686	\$1,592,261				
<b>Deposits:</b>						
Demand	\$219,743	\$229,639	11	43	0.02	0.08
Money market	322,737	221,508	342	91	0.43	0.17
Savings	125,134	117,408	9	14	0.03	0.05
Time	380,214	403,830	990	1,166	1.04	1.16
Total deposits	1,047,828	972,385	1,352	1,314	0.52	0.54
Customer repurchase agreements	49,239	47,607	14	1	0.11	0.01
Long-term borrowings	37,748	37,624	325	294	3.44	3.13
Total interest-bearing liabilities	1,134,815	1,057,616	1,691	1,609	0.60	0.61
Noninterest bearing demand deposits	386,024	323,135				
Other liabilities	9,073	9,825				
Shareholders' equity	206,774	201,685				
Total liabilities and shareholders' equity	\$1,736,686	\$1,592,261				
Interest rate spread					3.36%	3.28%
Net interest margin					3.54%	3.45%
Net interest income (taxable equivalent basis)			14,249	12,638		
Less: Taxable equivalent adjustment			337	478		

Net interest income	\$13,912	\$12,160
---------------------	----------	----------

41

---

Changes in Net Interest Income (Rate/Volume Analysis)  
(in thousands)

	Three Months Ended June 30, 2017 vs. 2016		
	Change		
	Increase Attributable to		
	(Decrease)	Rate	Volume
Interest income			
Loans:			
Commercial	\$265	\$(25 )	\$290
Real estate	1,911	(121 )	2,032
Consumer	(51 )	(48 )	(3 )
Total loans	2,125	(194 )	2,319
Securities:			
Federal agencies and GSEs	8	26	(18 )
Mortgage-backed and CMOs	(13 )	(6 )	(7 )
State and municipal	(534 )	13	(547 )
Other securities	49	42	7
Total securities	(490 )	75	(565 )
Deposits in other banks	58	58	—
Total interest income	1,693	(61 )	1,754
Interest expense			
Deposits:			
Demand	(32 )	(30 )	(2 )
Money market	251	195	56
Savings	(5 )	(6 )	1
Time	(176 )	(110 )	(66 )
Total deposits	38	49	(11 )
Customer repurchase agreements	13	13	—
Long-term borrowings	31	30	1
Total interest expense	82	92	(10 )
Net interest income (taxable equivalent basis)	\$1,611	\$(153)	\$1,764

Six months ended June 30, 2017 and 2016

Net interest income on a taxable equivalent basis increased \$2,071,000 or 8.1%, for the six months ended June 30, 2017 compared to the same period of 2016. The increase was primarily due to increased loan volume in the 2017 period compared to the 2016 period.

For the first six months of 2017, the Company's yield on interest-earning assets was 3.90%, compared to 4.01% for the same period of 2016. The cost of interest-bearing liabilities was 0.58% compared to 0.62%, primarily related to a five basis point decrease in the cost of deposits. The interest rate spread was 3.32% compared to 3.39%. The net interest margin, on a fully taxable equivalent basis, was 3.49% compared to 3.56%, a decrease of seven basis points (0.07%). The decrease in net interest margin was driven by lower yields on earning assets and reduced levels of accretion income.

The following presentation is an analysis of net interest income and related yields and rates, on a taxable equivalent basis, for the six months ended June 30, 2017 and 2016. Nonaccrual loans are included in average balances. Interest income on nonaccrual loans, if recognized, is recorded on a cash basis or when the loan returns to accrual status.

Net Interest Income Analysis (dollars in thousands)  
Six Months Ended June 30,

	Average Balance		Income/Expense		Yield/Rate	
	2017	2016	2017	2016	2017	2016
<b>Loans:</b>						
Commercial	\$224,833	\$194,137	\$4,294	\$3,830	3.85%	3.99%
Real estate	999,484	834,943	22,126	19,681	4.43	4.71
Consumer	5,230	5,336	181	371	6.98	14.06
Total loans	1,229,547	1,034,416	26,601	23,882	4.33	4.63
<b>Securities:</b>						
Federal agencies and GSEs	96,651	94,244	896	824	1.85	1.75
Mortgage-backed and CMOs	79,033	78,635	825	825	2.09	2.10
State and municipal	117,681	165,349	2,090	2,964	3.55	3.59
Other securities	16,781	15,810	365	278	4.35	3.52
Total securities	310,146	354,038	4,176	4,891	2.69	2.76
Deposits in other banks	52,702	56,157	234	125	0.90	0.45
Total interest-earning assets	1,592,395	1,444,611	31,011	28,898	3.90	4.01
Non-earning assets	125,915	127,081				
Total assets	\$1,718,310	\$1,571,692				
<b>Deposits:</b>						
Demand	\$217,847	\$230,504	21	80	0.02	0.07
Money market	314,235	213,391	583	166	0.37	0.16
Savings	124,694	117,529	19	28	0.03	0.05
Time	377,766	399,904	1,929	2,337	1.03	1.18
Total deposits	1,034,542	961,328	2,552	2,611	0.50	0.55
Customer repurchase agreements	47,184	46,008	15	2	0.06	0.01
Other short-term borrowings	5,884	—	27	—	0.92	—
Long-term borrowings	37,733	37,609	644	583	3.41	3.10
Total interest-bearing liabilities	1,125,343	1,044,945	3,238	3,196	0.58	0.62
Noninterest bearing demand deposits	378,558	316,699				
Other liabilities	9,283	9,443				
Shareholders' equity	205,126	200,605				
Total liabilities and shareholders' equity	\$1,718,310	\$1,571,692				
Interest rate spread					3.32%	3.39%

Edgar Filing: AMERICAN NATIONAL BANKSHARES INC. - Form 10-Q

Net interest margin 3.49% 3.56 %

Net interest income (taxable equivalent basis)	27,773	25,702
Less: Taxable equivalent adjustment	727	958
Net interest income	\$27,046	\$24,744

43

---



## Changes in Net Interest Income (Rate/Volume Analysis)

(in thousands)

	Six Months Ended June 30, 2017 vs. 2016		
	Change		
	Increase		Attributable to
	(Decrease)	Rate	Volume
Interest income			
Loans:			
Commercial	\$464	\$(125 )	\$589
Real estate	2,445	(1,253 )	3,698
Consumer	(190 )	(183 )	(7 )
Total loans	2,719	(1,561 )	4,280
Securities:			
Federal agencies and GSEs	72	51	21
Mortgage-backed and CMOs	—	(4 )	4
State and municipal	(874 )	(27 )	(847 )
Other securities	87	69	18
Total securities	(715 )	89	(804 )
Deposits in other banks	109	117	(8 )
Total interest income	2,113	(1,355 )	3,468
Interest expense			
Deposits:			
Demand	(59 )	(55 )	(4 )
Money market	417	311	106
Savings	(9 )	(11 )	2
Time	(408 )	(284 )	(124 )
Total deposits	(59 )	(39 )	(20 )
Customer repurchase agreements	13	13	—
Other short-term borrowings	27	27	—
Long-term borrowings	61	59	2
Total interest expense	42	60	(18 )
Net interest income (taxable equivalent basis)	\$2,071	\$(1,415)	\$3,486

## Noninterest Income, three months ended June 30, 2017 and 2016

For the quarter ended June 30, 2017, noninterest income decreased \$19,000 or 0.6% compared to the comparable 2016 quarter. Details of individual accounts are shown in the table below.

	Three Months Ended June 30, (Dollars in thousands)			
	2017	2016	\$ Change	% Change
Noninterest income:				
Trust fees	\$908	\$961	\$ (53 )	(5.5 )%
Service charges on deposit accounts	501	514	(13 )	(2.5 )
Other fees and commissions	733	656	77	11.7
Mortgage banking income	462	365	97	26.6
Securities gains, net	331	222	109	49.1
Brokerage fees	192	223	(31 )	(13.9)
Income from SBICs	6	72	(66 )	(91.7)
Other	215	354	(139 )	(39.3)
Total noninterest income	\$3,348	\$3,367	\$ (19 )	(0.6 )

Other fees and commissions were positively impacted by higher levels of debit card transaction volume. Mortgage banking income increased \$97,000 in the 2017 quarter compared to the 2016 quarter as a result of increases in the volume of originations. Also, the Bank added new mortgage originators in the Roanoke market in the fourth quarter of 2016 and the second quarter of 2017. Net securities gains increased \$109,000 in the 2017 quarter. Securities sales are used as needed for liquidity purposes and to facilitate asset liability strategy. Income from SBICs reflected a \$66,000 decrease compared to the 2016 quarter; this category of income is highly unpredictable. Other income decreased \$139,000 compared to the same quarter of 2016 primarily due to additional income from investments in limited partnerships in the 2016 period.

## Noninterest Income, six months ended June 30, 2017 and 2016

For the six months ended June 30, 2017, noninterest income decreased \$45,000 or 0.7% compared to the comparable 2016 period. Details of individual accounts are shown in the table below.

	Six Months Ended June 30, (Dollars in thousands)			
	2017	2016	\$ Change	% Change
Noninterest income:				
Trust fees	\$1,820	\$1,891	\$ (71 )	(3.8 )%
Service charges on deposit accounts	985	1,006	(21 )	(2.1 )
Other fees and commissions	1,445	1,328	117	8.8
Mortgage banking income	991	657	334	50.8
Securities gains, net	590	588	2	0.3
Brokerage fees	384	427	(43 )	(10.1)
Income from SBICs	32	238	(206 )	(86.6)
Other	372	529	(157 )	(29.7)
Total noninterest income	\$6,619	\$6,664	\$ (45 )	(0.7 )

Other fees and commissions were positively impacted by higher levels of debit card transaction volume. Mortgage banking income increased \$334,000 in the 2017 period compared to the 2016 period as a result of increases in the volume of originations. Also, the Bank added new mortgage originators in the Roanoke market in the fourth quarter of 2016 and the second quarter of 2017. Income from SBICs reflected a \$206,000 decrease compared to the 2016 period; this category of income is highly unpredictable. Other income decreased \$157,000 compared to the same period of 2016 primarily due to additional income from investments in limited partnerships in the 2016 period.



## Noninterest Expense, three months ended June 30, 2017 and 2016

For the three months ended June 30, 2017, noninterest expense increased \$1,055,000 or 10.9%. Details of individual accounts are shown in the table below.

	Three Months Ended June 30, (Dollars in thousands)			
	2017	2016	\$ Change	% Change
Noninterest Expense				
Salaries	\$4,733	\$4,031	\$702	17.4 %
Employee benefits	1,130	1,055	75	7.1
Occupancy and equipment	1,148	1,059	89	8.4
FDIC assessment	134	193	(59 )	(30.6)
Bank franchise tax	263	256	7	2.7
Core deposit intangible amortization	203	288	(85 )	(29.5)
Data processing	502	459	43	9.4
Software	271	274	(3 )	(1.1 )
Other real estate owned, net	68	76	(8 )	(10.5)
Other	2,259	1,965	294	15.0
Total noninterest expense	\$10,711	\$9,656	\$1,055	10.9

Salaries expense and employee benefits expense increased in the 2017 quarter as compared to the 2016 quarter as a result of additional compensation expenses related to our entry into two new markets in the fourth quarter of 2016. Full-time equivalent employees at the end of the 2017 quarter were 328, up from 302 at the end of the prior year quarter. The expense for the Federal Deposit Insurance Corporation ("FDIC") assessment decreased in the 2017 quarter as compared to the 2016 quarter due to the reduction in FDIC assessment rates effective the third quarter of 2016. Core deposit intangible amortization decreased in the 2017 quarter compared to 2016 as the amortization expense relating to the Company's acquisition of MidCarolina Financial Corporation ("MidCarolina") in July 2011 was an accelerated method and will be fully amortized in 2020. The increase of \$294,000 in other expenses over the same quarter of 2016 is primarily due to increased marketing and printing expenses related to the de novo offices and marketing campaigns in 2017.

## Noninterest Expense, six months ended June 30, 2017 and 2016

For the six months ended June 30, 2017, noninterest expense increased \$1,578,000 or 8.1%. Details of individual accounts are shown in the table below.

	Six months ended June 30, (Dollars in thousands)			
	2017	2016	\$ Change	% Change
Noninterest Expense				
Salaries	\$9,532	\$8,246	\$1,286	15.6 %
Employee benefits	2,313	2,169	144	6.6
Occupancy and equipment	2,216	2,158	58	2.7
FDIC assessment	263	381	(118 )	(31.0)
Bank franchise tax	519	512	7	1.4
Core deposit intangible amortization	368	576	(208 )	(36.1)
Data processing	989	903	86	9.5
Software	550	571	(21 )	(3.7 )
Other real estate owned, net	111	209	(98 )	(46.9)
Other	4,291	3,849	442	11.5
Total noninterest expense	\$21,152	\$19,574	\$1,578	8.1



Salaries expense and employee benefits expense increased in the 2017 period as compared to the 2016 period as a result of additional compensation expenses related to our entry into two new markets in the fourth quarter of 2016. Full-time equivalent employees at the end of the 2017 period were 328, up from 302 at the end of the prior year quarter. The expense for FDIC assessment decreased in the 2017 period as compared to the 2016 period due to the reduction in FDIC assessment rates effective the third quarter of 2016. Core deposit intangible amortization decreased in the 2017 period compared to 2016 as the amortization expense relating to the Company's acquisition of MidCarolina in July 2011 was an accelerated method and will be fully amortized in 2020. The decrease of \$98,000 in other real estate owned ("OREO") was primarily related to a loss on sale of OREO in the 2016 period. The increase of \$442,000 in other expenses compared to the same period of 2016 is primarily due to increased marketing and printing for marketing campaigns and the de novo branch openings in 2017.

#### Non-GAAP Financial Measures

The efficiency ratio is calculated by dividing noninterest expense excluding gains or losses on the sale of OREO by net interest income including tax equivalent income on nontaxable loans and securities and noninterest income and excluding (1) gains or losses on securities and (2) gains or losses on sale of premises and equipment. The efficiency ratio for the 2017 quarter was 61.76% compared to 60.91% for the 2016 quarter. The Company expects improvement in this ratio in coming quarters. This is a non-GAAP financial measure that the Company believes provides investors with important information regarding operational efficiency. Such information is not prepared in accordance with GAAP and should not be construed as such. Management believes, however, such financial information is meaningful to the reader in understanding operating performance, but cautions that such information not be viewed as a substitute for GAAP. The Company, in referring to its net income, is referring to income under GAAP. The components of the efficiency ratio calculation are summarized in the following table (dollars in thousands):

	Three Months Ended	
	June 30,	
	2017	2016
Efficiency Ratio		
Noninterest expense	\$10,711	\$9,656
Subtract: gain on sale OREO	(48 )	(37 )
	\$10,663	\$9,619
Net interest income	\$13,912	\$12,160
Tax equivalent adjustment	337	478
Noninterest income	3,348	3,367
Subtract: gain on securities	(331 )	(222 )
Add: loss on sale of fixed assets	—	8
	\$17,266	\$15,791
Efficiency ratio	61.76 %	60.91 %

Net interest margin is calculated by dividing tax equivalent net interest income by total average earning assets. Because a portion of interest income earned by the Company is nontaxable, the tax equivalent net interest income is considered in the calculation of this ratio. Tax equivalent net interest income is calculated by adding the tax benefit realized from interest income that is nontaxable to total interest income then subtracting total interest expense. The tax rate utilized in calculating the tax benefit for both the 2017 and 2016 quarters is 35%. The reconciliation of tax equivalent net interest income, which is not a measurement under GAAP, to net interest income, is reflected in the table below (in thousands):

	Three Months Ended June 30,	
	2017	2016
Reconciliation of Net Interest Income to Tax-Equivalent Net Interest Income		
Non-GAAP measures:		
Interest income - loans	\$ 13,832	\$ 11,707
Interest income - investments and other	2,108	2,540
Interest expense - deposits	(1,352 )	(1,314 )
Interest expense - customer repurchase agreements	(14 )	(1 )
Interest expense - long-term borrowings	(325 )	(294 )
Total net interest income	\$ 14,249	\$ 12,638
Less non-GAAP measures:		
Tax benefit realized on non-taxable interest income - loans	\$ (79 )	\$ (65 )
Tax benefit realized on non-taxable interest income - municipal securities	(258 )	(413 )
GAAP measures	\$ 13,912	\$ 12,160

#### Income Taxes

The effective tax rate for the second quarter of 2017 was 30.97% compared to 29.77% for the second quarter of 2016. The effective tax rate is lower than the statutory rate of 35% due to income that is not taxable for federal income tax purposes in both years. The increase in the effective tax rate is primarily related to a lower level of tax exempt municipal securities volume and income.

The effective tax rate for the first six months of 2017 was 29.68% compared to 29.98% for the same period of 2016. The decrease in the effective rate in the 2017 period compared to the 2016 period was the positive result of a change in accounting for employee stock compensation.

## Fair Value Impact to Net Income

The following table presents the impact for the three and six month periods ended June 30, 2017 of the accretible and amortizable fair value adjustments attributable to the July 2011 acquisition of MidCarolina and the January 2015 acquisition of MainStreet BankShares, Inc. ("MainStreet") on net interest income and pretax income (dollars in thousands):

	Income Statement Effect	Premium (Discount) Balance on December 31, 2016	June 30, 2017			Remaining Premium (Discount) Balance
			Accretion (Amortization) Three Months Ended	Accretion (Amortization) Six Months Ended		
Interest income/(expense):						
Acquired performing loans	Income	\$ (1,976 )	\$ 247	\$ 442		\$ (1,534 )
Purchase impaired loans	Income	(5,709 )	380	649		(5,060 )
FHLB advances	Expense	20	(6 )	(11 )		9
Junior subordinated debt	Expense	1,659	(26 )	(51 )		1,608
Net interest income			595	1,029		
Non-interest (expense):						
Amortization of core deposit intangible	Expense	\$ 1,719	(203 )	(368 )		\$ 1,351
Change in pretax income			\$ 392	\$ 661		

During the second quarter of 2017, the Company received a substantial payoff and a pay-down of two purchased credit impaired loans that resulted in \$220,000 in cash-basis accretion income.

The following table presents the impact for the three and six month periods ended June 30, 2016 of the accretible and amortizable fair value adjustments attributable to the two acquisitions mentioned above on net interest income and pretax income (dollars in thousands):

	Income Statement Effect	Premium (Discount) Balance on December 31, 2015	June 30, 2016			Remaining Premium (Discount) Balance
			Accretion (Amortization) Three Months Ended	Accretion (Amortization) Six Months Ended		
Interest income/(expense):						
Acquired performing loans	Income	\$ (3,061 )	\$ 216	\$ 473		\$ (2,588 )
Purchase impaired loans	Income	(7,066 )	167	942		(6,124 )
FHLB Advances	Expense	42	(6 )	(11 )		31
Junior subordinated debt	Expense	1,761	(25 )	(51 )		1,710
Net interest income			352	1,353		
Non-interest (expense):						
Amortization of core deposit intangible	Expense	\$ 2,683	(288 )	\$ (576 )		\$ 2,107
Change in pretax income			\$ 64	\$ 777		

Generally accepted accounting principles for business combinations require the acquired balance sheet to be valued at fair value at the time of the merger. In the context of acquiring a commercial bank, most of the balance sheet is interest rate sensitive and this can generate significant discounts or premiums to contractual values. These discounts or premiums will have a potentially significant impact to net interest income and to net income.





The table below summarizes the impact of the fair value acquisition related accounting adjustments on net interest income and total pretax income of the MidCarolina ("MC" for the table below only) and MainStreet ("MS" for the table below only) acquisitions for the three and six month periods indicated (dollars in thousands):

	Three Months Ended June 30, 2017			2016		
	MC	MS	Total	MC	MS	Total
Net interest income	\$413	\$182	\$595	\$178	174	\$352
Core deposit amortization	(151)	(52)	(203)	(226)	(62)	(288)
Total pretax income	\$262	\$130	\$392	\$(48)	112	\$64

  

	Six Months Ended June 30, 2017			2016		
	MC	MS	Total	MC	MS	Total
Net interest income	\$615	\$414	\$1,029	\$868	485	\$1,353
Core deposit amortization	(264)	(104)	(368)	(452)	(124)	(576)
Total pretax income	\$351	\$310	\$661	\$416	361	\$777

The MidCarolina acquisition was effective July 1, 2011 and the MainStreet acquisition was effective January 1, 2015. Management expects that the acquisition accounting financial impact of these acquisitions will continue to decline in future quarters.

#### Impact of Inflation and Changing Prices

The majority of assets and liabilities of a financial institution are monetary in nature and therefore differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. The most significant effect of inflation is on noninterest expense, which tends to rise during periods of inflation. Changes in interest rates have a greater impact on a financial institution's profitability than do the effects of higher costs for goods and services. Through its balance sheet management practices, the Company has the ability to react to those changes and measure and monitor its interest rate and liquidity risk. During the reported periods, inflation and interest rates have been low.

#### CHANGES IN FINANCIAL POSITION

##### BALANCE SHEET ANALYSIS

###### Securities

The securities portfolio generates income, plays a major role in the management of interest rate sensitivity, provides a source of liquidity, and is used to meet collateral requirements. The securities portfolio consists primarily of high credit quality investments, mostly federal agency, mortgage-backed, and state and municipal securities.

The available for sale securities portfolio was \$280,503,000 at June 30, 2017, compared to \$346,502,000 at December 31, 2016, a decrease of \$65,999,000 or 19.05%. At June 30, 2017, the available for sale portfolio had an amortized cost of \$279,433,000 resulting in a net unrealized gain of \$1,070,000. At December 31, 2016, the available for sale portfolio had an amortized cost of \$346,733,000, resulting in a net unrealized loss of \$231,000.

The Company is cognizant of the continuing historically low and recently volatile interest rate environment and has elected to maintain a defensive asset liability strategy of purchasing high quality taxable securities of relatively short duration. The Company is aware that possible changes in corporate tax rates could have a negative impact on its municipal portfolio valuation.

The Company has experienced relatively high growth rates for earning assets and somewhat less growth on deposits. Consequently, management has elected to selectively reduce portions of its securities portfolio in an effort to mitigate actual and anticipated liquidity challenges. During the first two quarters of 2017, the Company sold \$53.9 million in par value bonds and realized a net gain of \$590,000. This compares to the first half of 2016, when the Company sold \$8.8 million in par value bonds and realized a net gain of \$588,000.

The Company manages its investment portfolio on an aggregate portfolio basis for purposes of monitoring and controlling average life and duration. Accordingly, some individual purchases may fall outside these overall guidelines. The Company

50

---

will continue to deploy its cash to the maximum extent practical and prudent, consistent with its liquidity and asset liability strategies, and regulatory requirements.

#### Loans

The loan portfolio consists primarily of commercial and residential real estate loans, commercial loans to small and medium-sized businesses, construction and land development loans, and home equity loans.

Total loans were \$1,288,693,000 at June 30, 2017, compared to \$1,164,821,000 at December 31, 2016, an increase of \$123,872,000 or 10.63%. The increase is the result of organic growth and the de novo branch start-ups in Roanoke, Virginia and Winston-Salem, North Carolina.

Loans held for sale totaled \$2,379,000 at June 30, 2017 and \$5,996,000 at December 31, 2016. Loan production volume was \$39,030,000 for the six month period ending June 30, 2017 and \$78,330,000 for the year ended December 31, 2016. These loans were approximately 60% purchase and 40% refinancing.

Management of the loan portfolio is organized around portfolio segments. Each segment is comprised of various loan types that are reflective of operational and regulatory reporting requirements. The following table presents the Company's loan portfolio by segment as of June 30, 2017 and December 31, 2016 (dollars in thousands):

	June 30, 2017	December 31, 2016
Commercial	\$236,418	\$208,717
Commercial real estate:		
Construction and land development	132,322	114,258
Commercial real estate	590,093	510,960
Residential real estate:		
Residential	211,305	215,104
Home equity	113,580	110,751
Consumer	4,975	5,031
Total loans	\$1,288,693	\$1,164,821

#### Provision for Loan Losses

Provision for loan losses was \$650,000 for the six month period ended June 30, 2017, compared to \$100,000 for the same period ended June 30, 2016. The additional provision in the six month period ended June 30, 2017 resulted primarily from increased loan volume. The increase was mitigated by continued strong asset quality metrics and improving local and national economic indicators.

#### Allowance for Loan Losses

The purpose of the ALLL is to provide for probable losses inherent in the loan portfolio. The allowance is increased by the provision for loan losses and by recoveries of previously charged-off loans. Loan charge-offs decrease the allowance.

At June 30, 2017, the ALLL was \$13,632,000 compared to \$12,801,000 at December 31, 2016. The ALLL as a percentage of total loans was 1.06% and 1.10%, respectively.

As part of the Company's methodology to evaluate the adequacy of its ALLL, the Company computes its ASC 450 loan balance by reducing total loans by acquired loans and loans that were evaluated for impairment individually or smaller balance nonaccrual loans evaluated for impairment in homogeneous pools. The FASB ASC 450 loan loss reserve balance is the total ALLL reduced by allowances associated with these other pools of loans.

The general allowance, ASC 450 (FAS 5) reserves to FASB ASC 450 loans, was 1.10% at June 30, 2017, compared to 1.17% at December 31, 2016. On a dollar basis, the reserve was \$13,212,000 at June 30, 2017, compared to \$12,429,000 at December 31, 2016. The percentage of the reserve to total loans has declined due to improving local and national economic conditions and continued strong asset quality metrics. This segment of the allowance represents by far the largest portion of the loan portfolio and the largest aggregate risk.

The specific allowance, ASC 310-40 (FAS 114) reserves to FASB ASC 310-40 loans, was 0.45% at June 30, 2017, compared to 0.47% at December 31, 2016. On a dollar basis, the reserve was \$15,000 at June 30, 2017, compared to \$23,000 at December 31, 2016. There is ongoing turnover in the composition of the impaired loan population, which

decreased by a net

51

---

\$1,544,000 over December 31, 2016. Newly evaluated impaired loans did not have a significant impact on the overall impairment allowance.

The specific allowance does not include reserves related to acquired loans with deteriorated credit quality. This reserve was \$405,000 at June 30, 2017 compared to \$349,000 at December 31, 2016. This is the only portion of the reserve related to acquired impaired loans. Cash flow expectations for these loans are reviewed on a quarterly basis and unfavorable changes in those estimates relative to the initial estimates can result in the need for additional loan loss provision. The following table presents the Company's loan loss and recovery experience for the periods indicated (dollars in thousands):

Summary of Loan Loss Experience

	Six Months Ended June 30, 2017	Year Ended December 31, 2016
Balance at beginning of period	\$12,801	\$ 12,601
Charge-offs:		
Construction and land development	1	—
Commercial real estate	—	10
Residential real estate	11	21
Home equity	13	66
Total real estate	25	97
Commercial and industrial	23	40
Consumer	86	189
Total charge-offs	134	326
Recoveries:		
Construction and land development	5	11
Commercial real estate	10	21
Residential real estate	15	53
Home equity	7	15
Total real estate	37	100
Commercial and industrial	212	40
Consumer	66	136
Total recoveries	315	276
Net charge-offs (recoveries)	(181 )	50
Provision for loan losses	650	250
Balance at end of period	\$13,632	\$ 12,801

## Asset Quality Indicators

The following table provides qualitative indicators relevant to the Company's loan portfolio for the six month period and year indicated below.

## Asset Quality Ratios

	June 30, 2017	December 31, 2016
Allowance to loans	1.06	% 1.10
ASC 450 (FAS 5) ALLL	1.10	1.17
Net charge-offs (recoveries) to allowance <sup>(1)</sup>	(2.66 )	0.39
Net charge-offs (recoveries) to average loans <sup>(1)</sup>	(0.03 )	0.00
Nonperforming assets to total assets	0.31	0.29
Nonperforming loans to loans	0.29	0.30
Provision to net charge-offs (recoveries) <sup>(1)</sup>	(359.12)	500.00
Provision to average loans <sup>(1)</sup>	0.11	0.02
Allowance to nonperforming loans	365.67	360.39

(1) - Annualized.

## Nonperforming Assets (Loans and Other Real Estate Owned)

Nonperforming loans include loans on which interest is no longer accrued and accruing loans that are contractually past due 90 days or more. Nonperforming loans include loans originated and loans acquired.

Nonperforming loans to total loans were 0.29% at June 30, 2017 and 0.30% at December 31, 2016.

Nonperforming assets include nonperforming loans and OREO. Nonperforming assets represented 0.31% of total assets at June 30, 2017, up from 0.29% at December 31, 2016. This increase was related primarily to the increases in OREO and acquired impaired loans over 90 days past due and accruing.

In most cases, it is the policy of the Company that any loan that becomes 90 days past due will automatically be placed on nonaccrual loan status, accrued interest reversed out of income, and further interest accrual ceased. Any payments received on such loans will be credited to principal. In some cases a loan in process of renewal may become 90 days past due. In these instances the loan may still be accruing because of a delayed renewal process in which the customer has not been billed. In accounting for acquired impaired loans, such loans are not classified as nonaccrual when they become 90 days past due. They are considered to be accruing because their interest income relates to the accretable yield and not to contractual interest payments.

Loans will only be restored to full accrual status after six consecutive months of payments that were each less than 30 days delinquent. The Company strictly adheres with this policy before restoring a loan to normal accrual status.

The following table presents the Company's nonperforming assets as of June 30, 2017 and December 31, 2016 (dollars in thousands):

Nonperforming Assets	June 30, December 31,	
	2017	2016
Nonaccrual loans:		
Real estate	\$ 2,085	\$ 2,928
Commercial	25	19
Consumer	7	18
Total nonaccrual loans	2,117	2,965
Loans past due 90 days and accruing interest:		
Real estate	1,471	587
Commercial	140	—
Total past due 90 days and accruing interest	1,611	587
Total nonperforming loans	3,728	3,552
Other real estate owned	1,686	1,328
Total nonperforming assets	\$ 5,414	\$ 4,880

#### Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The following table shows loans that were considered impaired, exclusive of acquired impaired loans, as of June 30, 2017 and December 31, 2016 (dollars in thousands):

#### Impaired Loans

	June 30, December 31,	
	2017	2016
Accruing	\$ 1,183	\$ 2,059
Nonaccruing	2,117	2,785
Total impaired loans	\$ 3,300	\$ 4,844

#### Troubled Debt Restructurings ("TDRs")

TDRs exist whenever the Company makes a concession to a customer based on the customer's financial distress that would not have otherwise been made in the normal course of business.

There was \$1,798,000 in TDRs at June 30, 2017 compared to \$2,670,000 at December 31, 2016. These loans are included in the impaired loan table above.



#### Other Real Estate Owned

Other real estate owned was \$1,686,000 and \$1,328,000 as of June 30, 2017 and December 31, 2016, respectively. OREO is initially recorded at fair value, less estimated costs to sell, at the date of foreclosure. Loan losses resulting from foreclosure are charged against the ALLL at that time. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of the new cost basis or fair value, less estimated costs to sell with any additional write-downs charged against earnings. For significant assets, these valuations are typically outside annual appraisals. The following table shows the Company's OREO as of June 30, 2017 and December 31, 2016 (dollars in thousands):

#### Other Real Estate Owned

	June 30, December 31,	
	2017	2016
Construction and land development	\$ 139	\$ 139
1-4 family residential	928	653
Commercial real estate	619	536
	\$ 1,686	\$ 1,328

#### Deposits

The Company's deposits consist primarily of checking, money market, savings, and consumer and commercial time deposits. Total deposits were \$1,462,841,000 at June 30, 2017 compared to \$1,370,640,000 at December 31, 2016, an increase of \$92,201,000 or 6.73%. This growth is mostly in non-maturity, core deposits, the heart of our balance sheet. The Company's primary focus on the liability side of the balance sheet is growing core deposits and their affiliated relationships. The continuing challenge in this ongoing low rate environment is to fund the Bank in a cost effective and competitive manner. The Company's cost of deposits for the second quarter of 2017 was 0.52%, down from 0.54% for the second quarter of 2016.

#### Shareholders' Equity

The Company's capital management strategy is to be classified as "well capitalized" under regulatory capital ratios and provide as high as possible total return to shareholders.

Shareholders' equity was \$207,053,000 at June 30, 2017 compared to \$201,380,000 at December 31, 2016, an increase of \$5,673,000 or 2.82%.

The Company paid cash dividends of \$0.48 per share during the first six months of 2017 while the aggregate basic earnings per share for the same period was \$0.97 and diluted earnings per share for the same period was \$0.96 per share.

In July 2013, the Board of Governors of the Federal Reserve System issued final rules that make technical changes to its capital rules to align them with the Basel III regulatory capital framework and meet certain requirements of the Dodd-Frank Act. The final rules maintain the general structure of the prompt corrective action framework in effect at such time while incorporating certain increased minimum requirements. Effective January 1, 2015, the final rules require the Company and the Bank to comply with the following minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6.0% of risk-weighted assets (increased from the prior requirement of 4.0%); (iii) a total capital ratio of 8.0% of risk-weighted assets (unchanged from the prior requirement); and (iv) a leverage ratio of 4.0% of total assets (unchanged from the prior requirement). These are the initial capital requirements, which will be phased in over a four-year period. When fully phased in on January 1, 2019, the rules will require the Company and the Bank to maintain such minimum ratios plus a 2.5% "capital conservation buffer" (other than for the leverage ratio). The phase in of the capital conservation buffer began on January 1, 2016, at 0.625% of risk-weighted assets, increasing by the same amount each year until fully implemented at 2.5% on January 1, 2019. Management believes the Company and the Bank will be compliant with the fully phased-in requirements when they become effective January 1, 2019.

The following table provides information on the regulatory capital ratios for the Company and the Bank at June 30, 2017 and December 31, 2016. Management believes, as of June 30, 2017, that the Company and the Bank more than satisfy all capital adequacy requirements to which they are subject.

Risk-Based Capital Ratios:	Percentage At June 30, 2017		Percentage At December 31, 2016	
	Company	Bank	Company	Bank
Common equity tier 1 capital ratio	11.19%	12.16%	11.77%	12.92%
Tier 1 capital ratio	13.10	12.16	13.83	12.92
Total capital ratio	14.08			